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BANK OF CANADA

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ROYAL COMMISSION ON BANKING

AND FINANCE

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Hearings held at Ottawa, Ontario, on Wednesday, January 9, 1963.

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THE COMMISSION

The Honourable Dana Harris Porter
Chief Justice of Ontario
Toronto, Ontario - Chairman

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Vancouver, British Columbia

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Queen's University
Kingston, Ontario

\- - - - -

Mr. H. A. Hampson - Secretary

Mr. Gilles Mercure - Joint Secretary

Ottawa, Ontario,
Wednesday,
January 9, 1963.

--- At 9.15 A.M. the hearing resumed.

THE CHAIRMAN: I will call the meeting to order. This morning we shall hear a submission from the Bank of Canada.

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SUBMISSION OF

THE BANK OF CANADA

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APPEARANCES

Louis Rasminsky	- Governor of the Bank of Canada
J. R. Beattie	- Deputy Governor, Bank of Canada
R. W. Lawson	- Executive Assistant to the Governors, Bank of Canada
G. K. Bouey	- Chief, Research Department, Bank of Canada
G. E. Freeman	- Adviser, Research Department, Bank of Canada

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THE CHAIRMAN: Mr. Rasminsky, at last, after a rather long adjournment, we have come to the point where we shall hear your submission. We have been looking forward to this for some time.

I wish to thank you for the very great assistance you have been to this Commission. We have borrowed some of your very excellent staff. We have had the fullest co-operation from yourself and your colleagues on various occasions, and we feel very much indebted to you for all the help that you have given us. I understand that you wish to make a statement at the opening of the submission, and following that we shall be in a position to ask questions and carry on discussion with you and any members of your staff you may wish to call upon.

MR. RASMINSKY: Thank you very much, Mr. Chairman. May I begin by introducing my associates who are present:

Mr. J. R. Beattie, my Deputy; Mr. R. W. Lawson, Executive Assistant to the Governors; Mr. G. K. Bouey, the Head of our Research Department; and Mr. G. E. Freeman, Adviser in the Research Department.

I should like to express my gratitude to you for the kind remarks you made about the help we have been able to give the Commission, and your reference to the adjournment of these proceedings. I particularly appreciated it, as I am sure the other public witnesses did, for the original times scheduled for these hearings would probably have not produced as easy an exchange of views as I hope we shall be able to have on this occasion.

We in the Bank of Canada, as I have had occasion to tell you, atta.. great importance to the work of this Commission. We look forward very much

to reading your report, to see what decisions you have come to, what conclusions you have reached, as a result of your examination of the financial structure, and to see the numerous staff studies which I know have been undertaken.

Apart from this value, which is very great, which we attach to the work of the Commission, I believe that a commission of this sort has certain incidental values which are almost as great. For one thing I believe it makes people like ourselves think about their jobs, think about what it is that they are trying to do in their organizations, to sit back and take a look at their methods and objectives.

I may say I do not know whether you and your colleagues have learned a great deal about monetary policy as a result of reading the rather voluminous submissions that we made last May, but I can assure you that I learned a good deal about it in the course of helping to prepare these submissions. It has forced us in the Bank, and I am sure this is true of the other organizations that have given evidence to you, to think about our jobs in a coherent, constructive way, and I think that has been of real value. Certainly, in veiw of my own very limited experience as Governor of the central bank it has been an important part of my own on-job training during the past eighteen months.

These submissions are dated May 31, and were prepared at a time when we expected to be heard, I think it was in the month of July.

There are five formal submissions: The first is on the constitution and functions of the Bank of Canada, the second is on the role of monetary policy, the third is on the techniques of monetary policy, the fourth is on the role of the Bank of Canada in debt management, and the fifth submission is on the role of the Bank of Canada in foreign exchange.

In spite of the lapse of time since the end of May and the amount of water in various forms which has run over Niagara in the intervening months, there is nothing of a formal nature which we wish to add or subtract from these submissions.

Naturally we shall be very glad to provide any additional material that the Commission decides in the course of these discussions it would be useful for the Commission to have.

I take it, Mr. Chairman, that you will not wish me to read these May submissions, but I should like, as you have indicated, to make an opening statement, and to review briefly some of the highlights of the submissions.

I do not intend to touch on all the material in these submissions that I would regard as important, but there are a few matters on which I should like to try to extend the discussion a bit further than we did in our formal submissions.

1. <u>The Relationship between the Bank of Canada and the Government</u>

Our first submission deals with the constitution and functions of the Bank and is, for the greater part, an attempt to summarize the main provisions of the statute under which we operate. I imagine that the Commission will wish to question me about various aspects of this subject, and at the present time there is only one point on which I wish to comment. This is on the matter of the relationship between the Bank of Canada and the Government.

I have little to add in principle to what I said on this subject in the statement which I issued on August 1, 1961, shortly after I became Governor of the Bank. This statement appears as an appendix to our Submission II: The Role of Monetary Policy. The substance of the view that I then stated and that I continue to hold is contained in one sentence as follows:

> "I do not suggest a precise formula (i.e. a formula governing the responsibilities of the Bank and the Government in relation to monetary policy) but have in mind two main principles to be established:
>
> (1) in the ordinary course of events, the Bank has the responsibility for monetary policy, and
>
> (2) if the Government disapproves of

> the monetary policy being carried out by the Bank it has the right and the responsibility to direct the Bank as to the policy which the Bank is to carry out."

This view might be described as the principle of joint or dual rsponsibility, and it seems to me now to be firmly established doctrine in Canada. Certainly during my tenure of office as Governor of the Bank of Canada the relationship between the Bank and the Government has been completely in accord with the two principles involved. During my experience as Governor the monetary policy of the Bank of Canada has at all times been that which the Bank judged to be the appropriate policy in the circumstances, and the Bank accepts full responsibility for its policy. At the same time the Government has been fully and continuously informed of the policy being followed from time to time by the Bank, and the Government has at no time dissociated itself from the policy nor disclaimed responsibility. In my judgment the principle of joint responsibility for monetary policy is now well understood and widely approved in Canada, and is working well at the present time.

I take it that one of the tasks before the Commission is that of expressing a view on the Bank of Canada-Government relationship, and it is for this reason that I have thought that I should inform the Commission of my experience as Governor as well as of the opinions I expressed in August 1961. I

am pleased that the Commission is giving consideration to this matter, and that it will be bringing its independent judgment to bear on the question of whether the Bank of Canada Act is adequate in this respect or whether it is desirable to establish by legislative amendment a procedure by which the Government can formally assume direct responsibility for monetary policy in addition to the ultimate responsibility which lies with it in any event. If the Commission should decide in favour of recommending a provision in the Act which would explicitly authorize the Government to issue a directive on monetary policy to the Bank, it seems to me important that the provision recommended should be phrased in such a way as to ensure that any directive issued under it would be quite formal in character, that is to say, that it would be in writing and would refer to the authority under which it was issued, that it would be specific in its terms, and that it would be published within a relatively short period.

Whether or not the Act is amended along these or other lines it is of course essential, as I said in my statement of August 1, 1961, that there should be a consistent meshing together of all aspects of public financial and economic policy and in particular that monetary policy, fiscal policy and debt management policy should be carefully coordinated and purposefully directed towards attaining the over-all economic objectives of the community.

2. The Objectives of Monetary Policy

This brings me to the second main point on which I wish to comment, namely the objectives of monetary policy. Our submission of May 31, 1962 states (Submission II, paragraph 1) that the broad objectives of monetary policy are those of public economic policy generally, that in Canada these are rightly set high, and that they may be said to include: sustained economic growth at high levels of employment and efficiency, internal price stability and the maintenance of a sound external financial position, an equitable sharing of economic benefits and burdens and the maintenance of a high degree of economic freedom. Further on (Submission II, paragraph 60), we say that while central banks feel a particular obligation for seeing that adequate emphasis is at all times placed on price stability in the consideration of public policies, there does not appear to be any basic incompatibility between price stability and the other objectives of monetary policy.

There are a number of comments I should like to make by way of elaboration and clarification of these views. In the first place, I want to make it clear that this list of objectives is intended as a factual statement of the economic objectives which the community wants and regards as important -- not as a statement of objectives which the central bank thinks the community ought to want. It is not easy to formulate a precise statement of what the community would regard as satisfactory performance

of the economy and there are no doubt many ways in which our statement could be improved. However, it does serve to indicate our view that the community judges the quality of economic performance by a set of varied, complex and exacting standards rather than by any one simple test.

One sometimes hears people say that they think there is a conflict between price stability and the other objectives of economic policy. Much depends here on what is meant by this use of the word "conflict". It is certainly the case that what one might describe as conflicting considerations enter into virtually every decision on economic policy, but if the statement is intended to mean that our economic system is such that it is clearly impossible to achieve price stability along with the other objectives that we seek, then I would not agree. Nor do I see any reason for believing that policies involving a persistent rise in prices at an appreciable rate would make it any easier to achieve high employment and sustained growth over the longer run, to achieve continuing improvement in the basic efficiency and productivity of the economy, to achieve a balanced international position, or to satisfy the community's notions of equity in the distribution of income. In fact, the contrary is more likely to be true. The more the community anticipated and took steps to protect itself against the persistent inflation generated by such policies, the less reason would there be to expect even short-run stimulus from it;

and if the outcome was a persistent inflation of our cost-price structure in relation to that of our important trading partners, I do not see how the economy could continue on this course without chronic resort to exchange rate depreciation which would be in my view quite unacceptable both domestically and to other countries.

For my part, I am convinced that, in its pursuit of good economic performance, public economic policy will be more successful over time if it pays regard to the advantages of stability in the value of money as a means of achieving such performance. What this means in practical terms will vary from time to time. Economic policy should try to avoid overloading the economy because an overloaded price economy has little alternative but to find relief through price increases and excessive imports which would lead to exchange difficulties; on the other hand, it should avoid underloading the economy as a substitute for other steps which could help in achieving price stability.

Economic management is rarely confronted in normal peacetime circumstances with the necessity of combatting both substantial under-employment and substantial upward pressure on the price level at one and the same time. But if we in Canada should find that our economy tends to develop upward price pressures as it moves towards the levels of economic activity and rates of growth we think it is reasonable to attempt to achieve and maintain, then the constructive reaction of public policy would not be to abandon the objective of price stability or the objective of continued expansion but rather to enquire into the market imperfections that are causing the undesirable price performance. An appropriate concern for price stability should help to give this constructive orientation to public policy. I do not think that public policy can be satisfied to aim at anything less than achieving price stability at high levels of economic activity. I see no inherent conflict between these objectives and I do not regard concern with preserving the value of money as a limitation on the use of monetary policy in pursuit of the community's economic objectives.

Accordingly, when we in the Bank of Canada say that we feel a particular obligation for seeing that adequate emphasis is placed on price stability in the formulation of economic policy, this does not mean that we regard other economic objectives of the community, such as high employment or sustained growth, as being of any lesser importance, or that we believe that the toleration of unsatisfactory levels of employment

or rates of growth is a constructive or acceptable way for public policy to approach the problem of maintaining price stability. It means that we think that it is desirable to bear in mind at all times not only that price stability is in itself one of the objectives of public policy but also that concern for price stability is a helpful means towards the achievement of the other objectives.

3. The Nature and Importance of Monetary Policy.

The only other comments I wish to make on our submission on the role of monetary policy relate to the way in which the influence of the central bank is felt and the degree of importance that it is reasonable to attach to monetary policy in attaining the community's economic objectives. Very briefly, our view on the first point is that the central bank can have an influence on credit conditions, and that changes in credit conditions in turn have an influence on the demand for goods and services and on the flow of capital into and out of Canada. The way in which operations of the central bank have an effect on credit conditions is outlined in detail in our submission. The central bank controls the cash reserves of the banking system and this enables it to determine the general trend of total chartered bank assets and the "money supply" (currency outside banks and chartered bank deposits.) Changes in the assets of the chartered banks and in the money supply can have an important influence on credit conditions generally though they are by no means the only

factors at work. The trend of chartered bank assets and the money supply is of major concern to the Bank of Canada, not as an end in itself but rather as a means through which it can influence credit conditions.

We explain the connection between credit conditions and the demand for goods and services in the following way: (Submission II, paragraph 12)...

"Every spender must continually weigh the attractions and advantages of an increase in spending against the risks, difficulties and disadvantages involved in financing it, given the circumstances prevailing at the time. The extent to which spenders are willing and able to go on stepping up their rate of spending relative to their incomes, i.e. in pressing their demands for goods and services at the expense of their financial positions, will clearly be influenced to some degree by the conditions, both current and prospective, which confront them in financial markets. Relevant considerations include the current and prospective availability and cost of credit, the current and prospective interest or dividend return available on financial assets of various kinds, the current and prospective prices at which securities can be bought or sold and the associated risk of capital loss or chance of capital gain. Other things being equal, the more difficult, expensive or risky it

becomes to borrow (and the more attractive it becomes to acquire or hold financial assets) the greater will be the restraining influence of credit conditions on the demand for goods and services. On the other hand the easier, cheaper or less risky it becomes to borrow (and the less attractive it becomes to acquire or hold financial assets) the more stimulating will be the influence of credit conditions on the demand for goods and services."

Our submission goes on to explain that the tightening or easing of credit conditions is likely to be reflected in the availability of credit as well as in the effect on yields obtainable on financial assets, and at times the availability effects can be quite important.

I am aware that there are others who describe the mechanism through which central bank operations have an influence on the demand for goods and services in a somewhat different way, and I would not wish to claim that ours is the only way to view the process. However, I do not think that there is anything irreconcilable between our way of looking at the mechanism and that which others may prefer.

I come now to the question: how important is monetary policy?

I think there can be no doubt that used in an extreme fashion monetary policy could produce dramatic results. There is after all virtually no limit in theory to the extent to which interest rates could be allowed to rise or be driven up through monetary

contraction. On the other side, in theory there is virtually no limit to the extent to which the money supply could be increased. There are, however, important practical considerations which place real limitations on the range within which it is sensible to use monetary policy. These considerations are discussed in some detail in Section E of submission II and I do not propose to repeat them here. What I have to say today about the importance of monetary policy assumes that we are talking about the use of the instrument within some range set by these considerations. Indeed, I believe one of the most important contributions that monetary policy can make is to help keep credit conditions within reasonable limits so that the economy will suffer from neither the periodic credit crises of earlier times, on the one hand, nor from the disruptive effects of fears of inflation or of foreign exchange difficulties on the other.

The contribution that monetary policy is making towards attaining the community's economic objectives cannot be judged in isolation, since it is only one part of a whole mix of public policies in any given circumstances. With proper coordination, it can make an important contribution to the success of other public economic policies. For example, if an expansionary fiscal policy is appropriate in the economic circumstances, including the external financial position, then monetary policy coordinated with debt management policy may be able to prevent the increased borrowing requirements of the Government from producing inappro-

priate credit conditions. On the other hand, if the economic circumstances are such that budgetary surpluses are indicated in order to exercise a restraining influence on the demand for goods and services, monetary policy in conjunction with debt management policy can be helpful in ensuring that these do not produce inappropriate credit conditions.

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There can be no doubt that monetary policy has an important effect on the flow of funds through financial markets, including the flow of funds between foreign and domestic financial markets. International flows of funds can often be appreciably affected by relatively small changes in interest rates, and this in itself is a sufficient reason for a good deal of importance to be attached to monetary policy. Monetary policy can at times play a crucial role in the maintenance of a sound external position.

In our submission (Submission II, paragraph 5) we indicated that the central bank must over the years satisfy the need of a growing economy for a larger stock of money, and that in the course of doing so it can, over shorter periods, help to moderate undesirable swings in the level of over-all demand. A great deal of discussion of the impact of monetary policy relates to its possible effectiveness in helping to achieve short-term objectives such as the moderation of cyclical fluctuations. The empirical evidence regarding the strength of the impact of monetary policy over the short-run tends to be inconclusive and it is not surprising that this is so because of the wide range of non-monetary factors that affect spending decisions. As we state in our submission (Submission II, paragraph 20):

> "Business spending plans are often appreciably changed, for example, by the discovery of new production techniques, the

availability of new machinery and equipment, the discovery of new natural resources, changes in the cost of materials and labour and taxation arrangements and, more generally, by changes in the levels of current or expected business profits. Similarly, consumer spending plans are frequently changed by the appearance on the market of new or different goods and services, by changes in tastes and customs, and by changes in the actual or expected levels of personal income. These various influences give rise to continuous and sometimes sharp changes in the trend of total spending."

The effects of changes in credit conditions during the business cycle on the trend of spending (involving as they do not only changes in the cost and availability of new borrowing but also changes in the prices of existing financial assets) are, of course, extremely difficult to assess. When credit conditions are changing it is almost invariably the case that some of the other things which have an influence on spending decisions are also changing, and it is difficult to isolate the effects on spending decisions of changes in credit conditions alone. I do not say this is to suggest that the effects on spending decisions of changes in credit conditions within the range that it is feasible to contemplate within the course of the business cycle are dramatic; on the contrary I believe that their magnitude is generally over-estimated rather

than under-estimated.

The lag between the time when credit conditions change and the time when the full impact is felt on the level of domestic spending adds to the problems of trying to form an objective view of the importance of monetary policy in the moderation of cyclical fluctuations. I would not wish to attempt any precise estimate of the length of these time lags and it seems likely that they vary from one time to another. Here again the problem of measurement is a very difficult one. Even though the lag between the implementation of monetary policy and its effect on spending decisions may be fairly long, the length of the typical business cycle, particularly the expansionary phase, appears to me to be long enough to make it possible for monetary policy to make a worthwhile contribution to stabilization. In the case of international capital flows, monetary policy and changes in credit conditions can have a strong impact with very little lag.

I think that the main conclusion I would draw from these considerations is that monetary policy is important enough to warrant a considerable effort to try to get it right and to make as much use of as circumstances permit. It cannot carry the whole burden of regulating the general level of spending in the economy and maintaining a satisfactory external financial position, but in combination with other public economic policies it can make an important contribution.

4. Institutional and Technical Considerations.

I now turn to a range of questions having to do with the institutional structure of the financial system and with the technical arrangements and regulations under which it operates, including those which constitute the apparatus of monetary control. In our third submission we dealt in some detail with "The Techniques of Monetary Policy", and before referring to two or three of the highlights of this submission I would like to make a few general observations about the kind of financial system which in my view would be likely to best serve the community in the pursuit of its economic objectives.

In the first place, I think that this is a field in which there are great advantages to be gained by preserving and strengthening the best features of the price system. If the community is to place major reliance on market mechanisms to produce the results it desires, however, it is essential to have good markets -- and there is no automatic mechanism which ensures that all markets are good markets. Markets for credit are no exception. I am not at all sure that I could offer anything like a completely adequate description of what I mean by good credit markets if I were pressed, but some of the more obvious and important characteristics come readily to mind.

First, I would stress the importance of plenty of effective competition. Financial markets and institutions provide channels through which the needs of those with funds to lend or invest can be matched

against the needs of those whose spending plans require outside finance for their execution. A good financial system should provide a wide range of choice among alternative channels of credit both for borrowers and lenders, which would imply effective competition between various kinds of financial intermediaries, numerous competing instruments available, and broad financial markets linking the system together as an organic whole. It is important that new entrants into the credit business as well as innovations in financial techniques should get a fair chance to prove themselves in competition with existing firms and techniques. It is also important that the terms and conditions of credit contracts should be freely determined under competitive conditions in impersonal markets and should respond flexibly to changes in the pressure of supply or demand for credit.

Other desirable characteristics of a good financial system it seems to me, include adequate specialization and diversity. Within limits, I think it is desirable that financial institutions should specialize in particular fields of credit and develop their own individual expertise in catering to the particular requirements even of small groups of borrowers and savers whose needs differ to some extent from those of the great majority.

Finally, I would stress that markets for credit can work well only if they are permitted to do so by the customary practices, rules and regulations which govern financial behaviour. An unduly rigid

system cannot respond flexibly to shifting market forces, adapt to changing circumstances, or develop new ways of meeting new needs.

No doubt there is a good deal more of a general nature that could be said about the desirable characteristics of a good financial system, but perhaps I have said enough already to indicate the broad lines of my approach to questions of this sort. When one leaves generalities behind and begins to examine in detail the institutional structure and governing arrangements of our own financial system it is not at all easy to be sure what is and what is not both in accordance with the general interest and fair and equitable to all the particular interests directly involved. To make sure assessments is one of the main tasks of the Commission and I do not intend to usurp your functions.

In what follows, I propose to confine my attention to certain aspects of the institutional arrangements and regulations which constitute the existing apparatus of monetary control in this country with which the central bank is more directly concerned.

The essential features of this apparatus are described in our formal submissions to this Commission -- a fractional reserve banking system consisting of the Bank of Canada and the chartered banks, the latter being required by law to maintain average minimum cash reserves in the form of Bank of Canada notes and deposits equivalent to 8 per cent of their Canadian deposit liabilities. By agreement they also maintain average minimum liquid asset holdings (including cash reserves) equivalent to 15 per cent of their deposits. Through its open market transactions in Government securities and various other operations, the Bank of Canada exercises direct control over the total amount of cash reserves available to the chartered banks as a group, and thus over the broad trend of their total deposit liabilities. Subject to the observance of the agreed minimum cash reserve and liquid asset ratios, the chartered banks themselves determine the allocation of their funds among loans and investments.

In our submissions of last May we expressed certain tentative views concerning these arrangements. I do not propose to quote what was said in detail, but perhaps a brief summing-up of our general position regarding the adquacy of our technical powers vis-a-vis the chartered banks would be helpful. I would say that

the Bank of Canada's existing powers in this respect are broadly speaking satisfactory for most purposes and most situations. The Bank has open to it an adequate range of techniques for varying the total amount of cash reserves available to the chartered banks and this power, in conjunction with the minimum cash reserve requirements, enables it to influence the over-all rate of growth of the chartered banking system over time. I might interject here that under the existing formula for calculating the minimum cash reserve requirements the central bank is involved in rather more guesswork in its day-to-day cash management than it would like, and that we have been thinking about various possible changes in the formula which might improve the short-run predictability of chartered bank response without imposing an unduly rigid system. Perhaps I shall have a bit more to say about this particular problem later in these proceedings; at this stage I merely wish to note its existence as one of the minor difficulties that the central bank has encountered in operating under the existing cash reserve arrangements.

In the normal course of events the Bank of Canada's cash management operations have their direct and immediate impact on chartered bank holdings on liquid assets and Government bonds rather than on the trend of chartered bank loans. Chartered bank lending policies appear to be rather insensitive to cash management except when the banks regard their holdings of liquid assets and Government bonds as being close to minimum levels. The agreement by the banks to observe a

minimum liquid asset ratio can, in the view of the central bank, play a limited but nevertheless useful role in increasing the responsiveness of the chartered banks' lending policies to cash management. Use of the statutory power of the Bank of Canada to vary the cash reserve requirements applicable to the chartered banks would enable it to exert a more direct and immediate influence over chartered bank lending policies in exceptional situations where this seems to be urgently desirable. It might be desirable for the central bank to be able to achieve a similar result through methods which had a smaller impact on bank earnings, such as by varying the level of the minimum liquid asset ratio. Here too the Commission may wish to have some further elaboration of our ideas at a later stage in the proceedings.

The rapid growth during recent years of various types of financial institutions which compete directly with the chartered banks in various aspects of their lending and deposit business raises a number of important questions, including one on which I would now like to comment. This question is whether the operations of these institutions which are not subject to stipulated cash reserve or liquid asset requirements have constituted in practice a serious impediment to the effectiveness of a policy of monetary restraint in Canada on the occasions when this has been the aim of the central bank. My own feeling with regard to this important issue is that it has not. It is true that a contraction of the cash base of the credit system

brought about by the central bank must directly or indirectly affect a significant proportion of the institutions engaged in the business of extending credit if it is to be effective. My own reading of the evidence is, however, that the effects on financial institutions and markets have been in fact quite pervasive even though membership in the reserve system has been limited to the chartered banks and even though there has been a good deal of ridigity in chartered banks lending and deposit rates. Whether the response of the banks to cash reserve stringency takes the form of disposing of Government securities (and thus driving up market interest rates) or of raising their own deposit rates, other financial institutions are put under pressure to offer competitive returns on their own obligations if they are to avoid cash drains and retain their share of the flow of current savings; and sooner or later institutional lending rates generally must also be increased if normal operating margins are to be maintained. In general, unless financial markets are very badly compartmentalized and full of interest rate and other rigidities, pressure exerted at one point in the system is transmitted to other areas of the market through a variety of mechanisms, and results in a more or less general stiffening of interest rates and other credit terms affecting all borrowing channels.

The ability of the so-called "near banks" to grow at the expense of the chartered banks seems to

me to depend basically on the ability of the "near-banks" to offer relatively more attractive terms to those with funds to deposit or invest than are offered by the chartered banks and "near-banks" are able to earn on their loans and investments. This is mainly a matter of the particular legal provisions and customs which govern the operations of the various types of financial institution rather than of the form in which cash is depositied and held in reserve. If the chartered banks were able and willing to maintain their deposit rates at competitive levels and recoup themselves by raising their lending rates, I do not see why their membership in the fractional cash reserve system should prevent them from growing as rapidly as their competitors who are not members. The central bank aims at influencing credit conditions generally, not at restricting the rate of growth of chartered bank deposits as such to some preconceived rate.

In practice, of course, the chartered banks are restricted in the lending rates they can charge and in their participation in certain remunerative fields of lending, and this undoubtedly affects their ability to compete for funds by offering sufficiently attractive interest rates on time and notice deposits. I should imagine that this is one of the main reasons why the chartered banks have lost ground to their near-bank competitors during the past decade. On the other hand, I do not think there is much evidence that the competitive gains of the "near-banks" at the expense of the chartered banks have been unusually great during periods of

monetary restraint except in certain rather special cases, such as the gains made by the instalment finance companies in the field of personal lending during the early 1950's, before the general move of the chartered banks into the field of instalment-type personal loan plans. Nor do I believe that the special requirements of the banks as members of the fractional reserve system -- the need to observe the 8 per cent minimum average cash and 15 per cent minimum average liquid asset ratios -- have so affected bank earnings as to seriously restrict their ability to pay competitive deposit rates.

I would like to conclude my comments on the existing apparatus and arrangements for monetary control with a word concerning the Bank Rate. At the time our submissions to this Royal Commission were prepared last May I had intended to postpone any change in the existing method of setting the Bank Rate until the matter had been fully aired in the course of your series of hearings and I had received some indication of the Commission's views. As you know, however, this plan was overtaken by events and since June 24 last we have operated under a fixed Bank Rate system, while leaving the rate to money market dealers through purchase and re-sale agreements on a floating basis related to the treasury bill tender rate as before. It is too early yet to draw any firm conclusions as to how the new Bank Rate system has worked, but perhaps I might venture a comment about its performance as a signal. The initial increase in the Bank Rate to the new fixed level of 6 per cent in June was undoubtedly seen to be

a strong confirmation of a major change in monetary policy. In the case of the three subsequent reductions, however, the same cannot be said: what was underway was a more or less continuous, gradual and tentative modification in the emphasis of policy rather than any major turning-points in policy with unambiguous implications for the future.

Although it has been very short, I think that our recent experience with the Bank Rate as a signal has been significant. From time to time one hears the view expressed that every change in the Bank Rate reflects some clear change in the central bank's expectations about the future, and that the central bank announces its fresh assessment to the country by the Bank Rate change. This view that Bank Rate should be regarded as a signal seems to me to draw its nourishment from Bank Rate changes such as our move to 6 per cent in June and similar crisis-type action taken on occasion in other countries. But Bank Rate changes of this kind have been unusual, and one hopes that they will be so in future; in fact, inasmuch as one of the aims of policy can be said to avoid crises, one hopes to avoid them completely. In any event, much less dramatic changes are much more common, and these typically do not reflect any clear change in central bank expectations, but rather the more or less continuous, and usually slow, evolution of economic events.

The principal advantage of a fixed Bank Rate over a flexible Bank Rate lies in the element of stability that it can give to money market rates by tentatively placing an upper limit on their movement. This is a substantial advantage. The principal disadvantage of a fixed Bank Rate is that when it moves it moves by definite steps, and since the underlying situation does not usually move by steps but gradually, the timing of Bank Rate changes

is largely arbitrary. This arbitrariness is unavoidable under the fixed bank rate system but it does sometimes create difficult problems of timing for the central bank. If we develop a mystique about Bank Rate changes under which every change is supposed to be saying something about the future, we will, I think, be creating false expectations and complicating the normal use of this instrument by the central bank.

5. Monetary Policy and Debt Management

The fourth submission of the Bank of Canada to the Commission is called "The Role of the Bank of Canada in Debt Management". In the context of this submission debt management is taken to mean the management of that part of the Government's debt which takes the form of direct and guaranteed securities outstanding. Such management includes the determination of the terms of new security issues, arrangement for their marketing and servicing, and the operation of certain Government investment accounts.

There is nothing that I wish to add to this submission today, but I would like to take the opportunity of underlining what I think are the two most important points in it. The first is that in the field of debt management the role of the Bank of Canada is that of adviser to, and fiscal agent for, the Government. The decisions taken by the Government in this field are communicated on its behalf to the Bank of Canada by the Minister of Finance.

The second important point is that in some ways debt management is very similar to monetary management. Both can have an influence on credit conditions and both have their principal impact on the economy in that way. Debt management decisions have their influence on credit conditions by affecting the characteristics and the amounts of the various types of Government securities that are outstanding, thereby affecting the terms on which investors will hold them. Monetary policy exercises its influence on credit conditions in part by affecting the distribution of the outstanding Government securities between banks and other holders.

In these circumstances it is obvious that very close coordination between debt management and monetary management is desirable. I believe that a high degree of effective coordination is in fact being achieved, and in my experience this co-ordination is facilitated by the fact that the central bank acts as the Government's agent in debt management operations.

6. Monetary Policy and the Foreign Exchange Rate

I would like to make a few comments now on the subject-matter of our final submission which deals with the role of the Bank of Canada in foreign exchange matters. As we point out in that submission foreign exchange policy in Canada is determined by the Government and not the central bank, but there is a close inter-connection between monetary policy and foreign exchange policy.

Since May 2, 1962, we have had a fixed foreign exchange rate in Canada, with a par value (92.5 cents U.S.) established with the International Monetary Fund and with the Government fulfilling the normal undertaking of Fund members to keep the rate of exchange between the Canadian dollar and other currencies within one per cent on either side of the declared par value. The undertaking of Fund members to achieve this degree of exchange stability reflects the view underlying the exchange rate system of the International Monetary Fund, namely, that exchange rate stability is in the best interests of the individual countries which make up the international trading community. The Fund system does not, of course, require its members to cling to foreign exchange rates for their currencies that are inappropriate, and it provides facilities which give to each member the means of changing its declared par value to correct a fundamental disequilibrium in its position in a way which gains international acceptability and which is thereby most likely to be effective. The Fund system also makes provision for financial assistance to enable members to cope with short-term disequilibria in their balance of payments.

The means most immediately available to the Government to keep the foreign exchange rate within one per cent of the declared par value is direct intervention in the foreign exchange market to buy or to sell foreign exchange in the amounts necessary, and this it does, using the Bank of Canada

as its agent for the purpose. But since there is obviously some limit to the volume of direct Government intervention that is feasible, the successful operation of this exchange rate system requires that the underlying factors which influence the demand for and supply of foreign exchange should throw up something sufficiently close to demand-supply balance in the market to allow direct Government intervention to remain within the scale that is feasible. Since these underlying factors are themselves affected by the character and mix of public economic policies, the real means available to achieve over time the Government's declared exchange rate intentions is to achieve a combination of public economic policies which supports the Government's exchange rate policy.

Having recognized that it is fundamental to the success of public foreign exchange policy and to its contribution to the achievement of the community's economic goals that it be adequately supported by an appropriate combination of other public policies, I would like now to return to the part that we must expect to be played by fluctuations in our foreign exchange reserves if the fixed exchange rate system that we now have is to work well. These fluctuations are the shock-absorbers in the system, accommodating the short-run oscillations and disturbances in the flow of the country's foreign exchange receipts and payments and permitting a smoother adaptation of public policies to the needs of the external economic position. With a structure of

international transactions as large as ours, and containing as many potentially volatile elements, it must be expected that from time to time the changes in the level of our reserves will be very large, and we must therefore be prepared to accommodate them. Among the ways in which we must be prepared, I think particularly of three. First, we must have reserves large enough to absorb large losses. It is of course true, as we have seen, that in periods of crisis Canada can have ready access to massive international financial assistance, but I take it that we would want to be in a position to accommodate substantial fluctuations in the flow of our international receipts and payments without such assistance. Second, we must be prepared to deal with the Canadian dollar financing of large increases in our reserves. While this may raise some problems, I see no reason to suppose that they would be unmanageable. Third, and most important, Canadian public opinion must prepare itself to accept large fluctuations in our reserves. This will take some doing because we have no recent experience with a fixed rate system, and we had grown used to seeing very little movement in our foreign exchange reserves for years at a time under the fluctuating rate system. It will militate against the smooth operation of the fixed rate system if, instead of focussing on the underlying position of the country's balance of payments, public attention should be pre-occupied to an exaggerated degree with short-term changes in reserves which, though large, may be well within the country's

capacity to handle.

Perhaps one could say by way of summary that the satisfactory operation of any exchange rate system in Canada requires the support of an appropriate combination of public policies, and that there are in practice two additional requirements for the satisfactory operation of the fixed exchange rate system-- that the rate should be fixed within the range which is appropriate to the longer-run needs of the economy, and that there should be effective freedom to absorb large short-run fluctuations in the flow of foreign exchange receipts and expenditures through movements in the exchange reserves. While both of these requirements are essential, they should not be impossibly difficult to satisfy and if they are satisfied they will leave adequate scope for the constructive use of monetary policy within the framework of public economic policy.

That is the end of my statement, Mr. Chairman. I thank you for listening to it so patiently, and I am now prepared to face my inquisitors.

THE CHAIRMAN: Thank you very much, Mr. Rasminsky. In view of the length of your statement, I think we should now adjourn for twenty minutes.

--- Short recess.

THE CHAIRMAN: We will now resume. Are there any questions?

COMMISSIONER GIBSON: Mr. Chairman, I

have a few questions in the area of the objectives of monetary policy that I would like to ask Mr. Rasminsky. He has been good enough to elaborate a bit upon objectives this morning, and he has answered several of the questions I was proposing to ask him.

However, sir, I would like to start with your statement on objectives, and ask for elucidation of certain aspects of them. In the first paragraph of Section 2 you outline what the objectives of public economic policy are. You state that the broad objectives of monetary policy are the same as those of public economic policy generally, and that these include sustained economic growth at high levels of employment and efficiency, internal price stability and the maintenance of a sound external financial position, an equitable sharing of economic benefits and burdens and the maintenance of a high degree of economic freedom.

Then, in paragraph 59 of your Submission II you state:

"Central banks feel a particular obligation for seeing that in the consideration given to the proper 'mix' of public policies adequate emphasis is at all times placed on price stability ...."

This morning you elaborated a little more on the relationship between the emphasis on price stability

in your submission and the general objectives of a national economic policy. Does this mean that price stability is a special objective of the central bank because of its concern with money, but not necessarily any more important than the other objectives which you have stated?

MR. RASMINSKY: I think that the central bank, Mr. Gibson, would have all these objectives simultaneously, and would not feel -- at least, we do not feel in the Bank of Canada -- that it is necessary to establish a priority as between the objective of price stability -- the one to which you have referred -- and the other objectives which are related, for example, to unemployment and growth. This was the burden of my remarks this morning, that there is no inherent incompatibility between these objectives.

Indeed, as I argued this morning, we regard the policies that are directed towards the attainment of price stability as one of the means by which the other objectives can be achieved and should, in fact, be achieved.

We believe that an adequate emphasis on price stability as an objective will direct policy along constructive lines -- along lines that are pinpointed and that relate to specific situations. A bottleneck situation, for example, would be one illustration of that.

The broad answer I would make to your question is that the central bank has all the objectives

in mind at all times. If the question is: Why does the central bank feel any particular responsibility for - why does it emphasise - price stability as much as it does?, then I think I would answer that question, in addition to the answer that was incorporated in my statement this morning, in this way; I think I would say that the impact of policies leading to price instability is likely to be delayed. There are lags involved in the inflationary consequences of policies -- and there may be inflationary consequences to such policies -- that are directed exclusively to the other objectives. For this reason I think it is the case that though public opinion generally accepts price stability as an objective, the public is not as adequately organized in seeking to attain this objective as it is in seeking to attain some of the other objectives. It requires a longer view of the situation. It probably requires also some sophisticated knowledge of what the economic and price-making process is, and of how some of the other policies react throughout the economic system.

The central bank is in a position to take such a view, and I think that it may also be for reasons relating to the organization of the support for various objectives that most central banks do feel a special responsibility, and I think also feel that the public expects them to feel a special responsibility for,the attainment of a reasonable price stability.

But I come back to the pointfrom which I started and I say that in our judgment such an emphasis on price stability is not by any means incompatible with the achievement of the other objectives.

COMMISSIONER GIBSON: Thank you, Mr. Rasminsky. There is one central bank in Europe, at least one, I understand, which is instructed in its legislation to concern itself with the stability of the internal and external value of the currency, and this is its prime responsibility as such. Other portions of the governmental organization concern themselves with, let us say, the mesh, the mix, of economic policy.

Do you think there is any merit in that kind of an approach or do you think a central bank ought to have all these objectives in front of it all the time?

MR. RASMINSKY: I think the latter, Mr. Gibson. I think that it would be a mistake to incorporate into the legislation any specific instruction to the central bank to focus its policies and its attention exclusively on the achievement of any single objective.

In our Bank of Canada Act there is a reference, not in exactly the type of language that we use today but rather similar language, to the variety of objectives that the central bank has. The preamble reads:

> "Whereas it is desirable to establish a central bank in Canada to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action..."

And so on.

COMMMSSIONER GIBSON: Now, looking at the objective of price stability to start with, what is in your opinion reasonable fulfillment of that objective? To elaborate a little more on the question, what is a tolerable long-range increase in the price level or is any long-range increase in the price level tolerable? Obviously, there will be increases in some years and declines in others, so that in any given year presumably one would be willing to see a certain degree of latitude, but as a regular diet what is consistent with the idea of price stability?

MR. RASMINSKY: I would not like to agree, Mr. Gibson, that any degree of continuous increase in the price level, or any degree of continuous erosion in

the value of money, is consistent with the idea of price stability. Of course, by price stability one does not mean price rigidity. It is obvious in a progressive, dynamic society where resources are being moved from one industry to another industry, where people are changing their jobs, where some things will be expanding and other things will be declining, and where prices will be affected by demands originating not only inside the country but also outside the country, that there will be constant shifts in relative prices and these shifts in relative prices are an essential part of the process of a functioning economy and will be responsive to the demands of various sorts that are being made on it.

The concept of price stability must, therefore, make provision for shifts in relative prices. It seems to me that there are two general principles that one would have in mind in attempting to answer your question as regards to the over-all level of prices. One principle would be that a price movement would be regarded as falling outside the range of price stability if it set into motion cumulative processes, if the price movement was large enough to lead various sections of the community to protect themselves against the effect of the price movement, so that you had a fresh starting point -- that I think would be incompatible with the conception of price stability.

A second general consideration that I think one would have to have in mind would be the comparison with other countries. If other countries had targets

which they were able to attain which came quite close to involving little or no upward movement in prices, then obviously the tolerance of an upward movement of prices here would lead to international trade difficulties, repercussions of our balance of payments, etcetera.

COMMISSIONER GIBSON: We have had it suggested to us that there is a strong tendency for prices of services to increase over a period of years, and this has been the case in recent times --

MR. RASMINSKY: Mr. Gibson, I am sorry but I did not hear the beginning of your question.

COMMISSIONER GIBSON: We have had it suggested to us in evidence that there is a strong tendency for the price of services to increase over a considerable period of time, and this has indeed been the case in recent times, and that if you do not allow some latitude for a long-term price increase the implication may be that the price of goods would have to go down to offset this long-range increase in the price of services, and that if the price of goods go down, or there is a tendency for them to drift down over a period, that this might well have an unfavourable effect on investment and other decisions. Would you care to make any comment on that?

MR. RASMINSKY: Yes, I would, Mr. Gibson. I think you are moving now to a rather different question to the one with which I was just trying to deal. You are moving now to the question of the measurement of price stability, and my previous remarks were related to the concept of price stability rather

than to its measurement.

There are difficult problems connected with the measurement of prices, in fact there are difficult problems connected with what one precisely means by price stability, and I did not mean, in what I said before, to imply that it was my view that price stability necessarily meant stability in any single measure of prices that one might think of.

There are various measures of prices that are available, and some additional measures that have been suggested as significant but which are not available in Canada.

I suppose in a way the most general measure of price movement available would be the deflator of the gross national product, but that is not a particularly good measure because it is influenced by the shifting composition of the gross national product. The wholesale price index is a fairly volatile index. It includes a good deal of internationally traded goods.

Another index to which a great deal of importance is attached is the cost of living index, or the consumer price index, as an over-all measure of prices. This is indeed a very important index because it is so regarded and figures very prominently in public discussions and wage negotiations, and so on.

COMMISSIONER GIBSON: And it has a large element of services in it as well.

MR. RASMINSKY: It has a large element of services in it, yes. Another index that has been suggested as a significant one is an index of the prices

of domestically-produced manufactured goods. I do not believe we have such an index in Canada.

You have mentioned one aspect of the cost of living index which has to be taken into account, and I think that there are some problems connected with the inclusion of services. I am not sure whether the problems are of the type that is generally referred to, namely, that the increase in productivity in the service industries is less than in the goods-producing industries and that, therefore wage increases give rise to an upward bias in prices in the service industries.

I am not sure whether that is the problem or whether it is the problem of the measurement of services. Different units of service mean different things. The cost of hospital services, for example, I understand, is measured by the price that you pay for room in a hospital for a night. Well, now, over a period of time what you get out of spending on a room in the hospital overnight has changed a good deal. You may get diagnostic or therapeutic service facilities of various sorts which represent a real improvement in the quality of what you get, which keeps you in the hospital fewer nights than you used to stay for the same ailment.

There are other problems connected with the use of the cost of living index. They apply to services and they also apply to other things, and these are the problems of lags.

This is an index which, since it is at the consumer level, reflects the impacts of demands

not at the time that you look at the index but impacts that were first felt sometime before. So that in a sense the consumer price index, unless you make allowance for this, may be more a guide to how good or bad policy has been in the past than it is a guide to what the current state of pressure of demand is, which I suppose is what one is trying to get at in consideration of monetary and other public policies.

The consumer price index is also affected by other factors that are not indicative of the current state of demand. It is affected, for example, by indirect taxes which may change from time to time, and in a discrete rather than in any continuous way. It is affected by crop conditions which are not related to the current state of demand.

I think that what all this adds up to, in my opinion, is that you cannot simply look at the consumer price index or any other single index and say, "there we have it. That is the measure of price stability". It is important to look at the consumer price index and all other indices, and I would agree that in looking at the consumer price index one should have in mind that for some of the reasons I have mentioned

there probably is some upward bias in the index which is inherent and which results from factors other than the pressures of total demand.

COMMISSIONER GIBSON: That is very interesting, indeed, Mr. Rasminsky. I was thinking really of what your broad view would be as to what was a reasonable guide, not what would be a sensitive

guide, as to the immediate short-term effectiveness of monetary policy, for it would seem to me to be very difficult to find an index that would do that exactly for you, but what over the years would be a reasonable guide as to whether prices were seriously rising or whether they were more or less level?

MR. RASMINSKY: I should like to look at all these various indices that we have mentioned.

COMMISSIONER GIBSON: Yes. Changing now the line of questioning a little bit, you have said on several occasions in your comments here this morning, and you also state in the second paper in paragraph 60, and more fully in your preliminary remarks this morning, that economic growth at high levels of employment and efficiency can more readily be obtained under conditions of reasonable price stability.

You put the same point of view from another angle this morning a little differently when you said:

> "... nor do I see any reason for believing that policies involving a persistent rise in prices at an appreciable rate would make it any easier to achieve high employment and sustained growth over the longer run."

We have received a lot of opinions on this matter, some of them highly contradictory in the evidence submitted to this Commission, and we certainly have not received any conclusive evidence from our point of view, to my mind, at any rate. This is relating price increase to high employment and economic growth and whether price increases do impede reasonable economic growth and good employment results.

MR. RASMINSKY: The proposition we have stated, Mr. Gibson, is that these two objectives are not incompatible.

COMMISSIONER GIBSON: But you go on from that.

MR. RASMINSKY: It is my judgment that adequate attention to price stability will indeed help to achieve the other objectives.

As to the evidence on the relationship between inflation and growth, between price stability and other things, the evidence I have seen is not conclusive one way or the other. The evidence does not point to the fact that price stability, that is relative price stability, is incompatible with growth, nor does it point in the opposite direction. I am sure that your own staff has done as much by way of assembling the evidence as we have done.

COMMISSIONER GIBSON: These studies have suggested that the evidence is inconclusive.

MR. RASMINSKY: I would agree that the evidence is inconclusive. To establish the point I made, it is sufficient to show that the evidence is inconclusive, because it is obvious that if we could attain price stability along with full employment and adequate growth, that would be a more desirable combination than to obtain growth at the expense of price stability.

COMMISSIONER GIBSON: You say this mainly on the grounds of equity, do you, your objective of a fair distribution of benefits and burdens of

our economic situation?

MR. RASMINSKY: I say it partly on the ground of equity, yes, but I say it also on the ground that it is my judgment that if a country were to go after the objectives of employment and growth without an adequate regard for price stability, it would run some quite serious risks in doing so.

Let me say this: the benefits that one derives from the inflationary processes, such as they are in the short run are, in my judgment, dependent on the lags in the economic system. They are dependent on the failure of certain elements of the community to protect themselves adequately against rising prices, through the pushing up of prices of whatever it is that they themselves have to sell by way of goods and services.

If one were to go in for inflationary policies as a continuing process, then the community would certainly soon learn to protect itself against the consequences through constantly rising costs, constantly rising interest rates, and so on, and you would be back where you were before without having derived any perceptible benefit.

In other words, I suppose it is possible on a theoretical model to make an inflationary system work, but if you can achieve the other objectives without going through that process, why go through it?

I referred a moment ago to some of the specific dangers that are involved in not giving

adequate emphasis to price stability, and concentrating on the other objectives, even to the acknowledged cost of price instability.

I cannot produce empirical evidence to establish these points, but it would seem to me that a continuing depreciation in the value of money would tend, if anything, to make people less willing to save, less willing to provide funds for the investment process, and for that reason might well lead to a lower growth rate than would occur under more stable monetary conditions. It would seem to me also that the particular stimulus given to particular industries in the course of the inflationary process would aggravate the problems of cyclical instability and make it more difficult to have a continuous growth in the economy.

Finally, a country that goes in for this process at a more accelerated rate than other countries would certainly get into balance of payments difficulties as a result and would be brought up short at some stage or other, with the result that the process would come to an end.

COMMISSIONER GIBSON: There seem to be quite a lot of countries which perhaps not by choice but in any event in fact do run sort of continuous inflations, and many of them have quite good rates of growth. Needless to say, I am not espousing this point of view, but would you think it is possible that substantially rising prices do stimulate initiative and keep things moving faster,

even in an economy that is used to this sort of thing and has adjusted itself to it.

MR. RASMINSKY: I think I would find it easier to answer your question, Mr. Gibson, if you would outline how you think the inflationary process stimulates the economy. What are the mechanisms?

COMMISSIONER GIBSON: I don't think so; I am just asking you. I think you have expressed your opinion, and perhaps we should leave it at that.

MR. RASMINSKY: If I may come back to the last point that you made, it may be the case, as you say, although at the moment I am not able to think of a very good example of it, that there are some countries in which you have a combination of inflation and rapid growth. It is also the case that there are countries in which you have a combination of inflation and low rates of growth. There are some countries in which there is an absence of inflation and rapid rates of growth.

It is always dangerous to mention examples, because the person to whom one mentions them will say, "Yes, but that is a special case", and he will probably be right. An example of a country with an absence of inflation and rapid rate of growth was Germany until quite recently when apparently that country has attached less importance to price stability.

Finally, to come back to the list: it is possible to have an absence of inflation and a

poor rate of growth. These various combinations are possible. Though four combinations are possible, one combination is the best of the four. I do not think it has been established that there is some basic incompatibility between price stability, however one thinks of it, and adequate growth rates. Then it seems to me that the objective of public policy should be to combine these two things.

COMMISSIONER GIBSON: Would you care to say a little about the practical limitation to the achievement of price stability, looking at it perhaps from the standpoint of conflicts which may arise between internal and external stability? One of the objectives which you state is sound external financial position. I suppose one might translate that now into the maintenance of a fixed rate of exchange, and adequate reserves. Would that be reasonable?

MR. RASMINSKY: That would be a reasonable starting point, but I think there is more to it than that. I suppose the basic thing in the maintenance of a sound external financial position is to be able to pay your bills, no matter what sort of exchange system you are on. That is, there should be a sufficient closeness in the balance of your expenditures and your income that you can meet the bills without difficulty out of your reserves.

Some countries really stop the analysis there and concentrate entirely on the cash position, and would regard changes in their reserves as being the most significant element in the soundness of their

balance of payments. This is the case in the United States, for example, where the whole balance of payments presentation is in terms of changes in the liquid claims of foreigners on the United States, and changes in their gold reserves; they tend to regard their balance of payments position as being in deficit even though the basic elements in their balance of payments position -- for example, their current accounts position -- as we would regard them, are very strong.

In considering what I say about a strong external financial position, I think one has to look beyond the cash position, the changes in reserves, and think of the composition, of what is entering into the international transactions. In this connection I think the distinction that we ordinarily make as between the current account and the capital account is a valid distinction and an important one. We naturally think of our external position as involving a current account deficit, since we have had one for so long.

The first point, I suppose, one would make is that the inflow of capital must be sufficient to cover the current account deficit without putting undue pressure on reserves. But there again, in thinking of inflow of capital, one should make a further distinction based on the character of the capital, as between short term and long term capital. A current account deficit which is financed largely through the inflow of short-term capital money

no doubt helps you balance your accounts and keeps your reserves within reasonable range; but a continuous balancing of a current account deficit through an inflow of short-term capital is an unsound position, and is not one that you would expect to maintain for a long period of time because of the reversibility of short-term capital flows.

It seems to me there is a third consideration. We have had two: one is the cash position, and the other is the nature of the capital inflow, if what you are talking about is current account deficit. The third consideration, it seems to me, is size of the deficit itself, even though it may be covered through long-term capital inflows.

Here I am expressing an opinion on a subject which in a sense is not the responsibility of the central bank, but as one man's opinion for what it is worth I think there is reason for regarding the size of the current account deficit as a factor to be taken into account in determining whether your external position is sound or not. The views that you would form on this would of course depend partly on the state of evolution the country is in, how advanced its economy is. That would depend in part on the stage of the business cycle you are in. For example, if one is incurring a large current account deficit at a time when there are very heavy new investment projects going on in the country, so that one can relate two things at least notionally, and feel that the counterpart of the

increased foreign indebtedness is the increased capacity to export, which will increase the transfer capacity of the country, that is one situation. If export capacity is not being incurred at such a time, that is another situation.

Another consideration one would take into account, it seems to me, in thinking of the size of the deficit that is appropriate for a country to incur, is the position of that country in the world and the standard of living it maintains.

If the country has a very high standard of living, then having in mind the capital requirements of countries less able to provide for their own capital expansion, it might be thought that the overall objective of policy over a long period of time involved in the maintance of a sound external position would be not to draw resources from the rest of the world, but rather to arrive over a period of time at a position where one was starting to repay some of the debt previously incurred in providing the resources to the rest of the world. These are among the considerations that seems to me one would keep in mind in determining what is a sound external position.

COMMISSIONER GIBSON: In other words, in our present environment an underlying objective of public economic policy might be to try and reduce our balance of payments deficit and achieve a somewhat less vulnerable position as a long-range policy?

MR. RASMINSKY: I quite agree with that statement, Mr. Gibson.

COMMISSIONER GIBSON: Well now, you have said there is a lot more behind the fixed exchange rate than just what you see on the surface; you have got to get in and look at the balance of payments position which we have and what the capital flows are and what it means in terms of our economic development, and so on, and to have a fixed rate of exchange, I take it you would agree, is an immediate modification to the central bank's power to maintain a policy of price stability and you have attached yourself to world price

systems; am I correct?

MR. RASMINSKY: Yes, any exchange rate attaches you to the world price system. The difference between the fixed rate in that respect and a fluctuating rate is that under a fixed rate regime you know what the multiplier is. Under a fluctuating rate regime you do not know until the event what the multiplier has turned out to be. In other words, I don't think that there is anything special about the fixing of the exchange rate which produces an impact on the Canadian economy, of conditions abroad or of prices abroad.

COMMISSIONER GIBSON: Let me be more specific. Do you think as a practical matter of national economic policy that we can expect to do much better than the Americans in the realm of price stability? I don't say that this is a serious limitation.

MR. RASMINSKY: I would say that what the Americans do in that field, as in others, is bound to have a great deal of influence here, Mr. Gibson, yes.

COMMISSIONER GIBSON: Well, coming to the question of high level employment, and again looking at the basic objectives, you describe this one in a somewhat broader scope as sustained economic growth and high level employment and efficiency.

If you don't mind, I would like to deal with these high levels of employment first and have a look at them. This is one of the most widely accepted popular national and economic objectives and perhaps the most widely accepted. Could you give us any idea of when the objective of high employment deserves an especially high

priority in relation to the objective of stable prices? You made some remarks this morning, stating that you did get into problems when the economy was overloaded, that prices tended to rise. There is a whole variety of technical jargon in this area; some people talk in terms of unemployment rates and some people talk in terms of the economy being overloaded, and so on and so forth, and at some point or other when so much pressure is put on the economy prices tend to start to rise very quickly and I should say that in some of the past studies we have done this is one of the things we have looked at, the relationship between unemployment rates and prices.

There is no very conclusive evidence that comes out and this is because we are working on a short period of time and so many other factors that bear on these relationships. Nevertheless, it does look as though when the unemployment rate starts to go under five per cent, and particularly as it approaches three per cent the price level does show some tendency to rise. This is another way of saying that somewhere in here the economy may be beginning to get overloaded, and I wonder if you would care to express your view on this matter? One of the things we are interested in getting are some bench marks here on what are reasonable relationships, where are the danger signs or signals?

MR. RASMINSKY: Yes, this is an interesting and important problem and I know that a lot of attention has been paid to it recently by economists, and I believe that I am right in saying that the Administration in

the United States has come up with a bench mark in this field. I believe that their present bench mark is an unemployment rate not exceeding four per cent.

I don't think I would feel competent, Mr. Gibson, to suggest a figure for Canada. Obviously, there are many different components to unemployment. There is a good deal of seasonal unemployment in this country on account of our climate and perhaps it could be reduced and some steps are being taken to reduce it.

COMMISSIONER GIBSON: I think it is a little unfortunate that we talk about this in terms of the unemployment rates. If you had a measure of overloading, or something of this kind, it would be a more useful way of discussing it.

MR. RASMINSKY: Yes, it would. I believe that some of the British analysis would seem along that line, of the percentage of utilization of capacity that may give rise to inflationary price increases. But we do have various types of unemployment here as elsewhere, but seasonal unemployment is, I suppose, likely to remain larger here than in the United States.

Another type of unemployment that is used in analysis, as you know, is fictional unemployment, which is largely determined by the time it takes new entrants into the labour market to find jobs, but people refer to structural unemployment as being the sort of unemployment that exists even under conditions of large demand for labour, because you don't have the people with the right skills in the right places.

Finally, you have this cyclical unemployment

of a type that reoccurs and might be relieved through changes in the pressure of demands. I would not be prepared or, as I say, competent to say at what point the addition of these various factors in Canada, or what the magnitude of the unemployment figure is that one could aim at without risk of producing excesses should be, but the only thing I would be prepared to say about that is that it is a figure which is considerably below the present level of unemployment. In other words, I believe that there is undoubtedly slack here that can be taken up, or another way of saying this is that at the present time I see no need to think in terms of choosing between the objective of relative price stability and increased employment and growth.

COMMISSIONER GIBSON: In other words, you have a fairly clear objective of increased employment and of growth now unimpeded by restrictive implications from the price set-up.

MR. RASMINSKY: I think that objective should be attainable by means which do not produce price instability.

COMMISSIONER GIBSON: Do you think this idea of what an acceptable level of capacity operation is varies from time to time depending on the circumstances?

MR. RASMINSKY: Yes, I would think it would, Mr. Gibson, and I think not only would it vary, not only would the idea of what is acceptable vary, but I think what would indeed be acceptable -- what would in fact be acceptable -- would vary.

Take some of these elements in unemployment

that we have been talking about, the seasonal element in unemployment. I think that there are some calculations that suggest that over the years on an average that the seasonal element in unemployment here may be as much as one and one-half per cent of the labour force. Is that right?

MR. BOUEY: Yes.

MR. RASMINSKY: Something can be done about that if that is tackled as a problem.

COMMISSIONER MACKINTOSH: You mean that something can be done but not by monetary policy?

MR. RASMINSKY: That is exactly what I mean, Dr. Mackintosh. Thank you very much for making that clear. So, if you take the structural unemployment that we spoke of, and I have the impression that there is a considerable element of structural unemployment in our present employment situation, and that certain skilled job requirements which at the time of the previous periods of high employment, high labour demand, were filled by skilled workers from the immigrant labour force, that these jobs are unfilled because we have not developed in adequate degree the skills ourselves.

There are various plans, again of a non-monetary sort, in progress at the present time to increase the skill of the labour force and to increase its mobility, so this should have an effect in reducing the real degree of unemployment that it is possible to contemplate, without excessive pressure on demand giving rise to unacceptable price increases.

COMMISSIONER GIBSON: That is really what

you were driving at when you said this morning that the reaction to public policy would not be to abandon the objective of price stability or the objective of continued expansion,but to enquire into the imperfections that are causing an undesirable price performance.

MR. RASMINSKY: Precisely, yes.

COMMISSIONER GIBSON: You still would not care to give what you thought the point of balance in this thing was?

MR. RASMINSKY: In terms of a single figure of arithmetic?

COMMISSIONER GIBSON: Roughly.

MR. RASMINSKY: Let the record indicate that the witness shook his head negatively!

COMMISSIONER GIBSON: There is one other aspect of this which I would like to ask you about. In section II, paragraph 73, you do intimate that policies of expansion may at times be limited or, I think, "inhibited" is the word you used, by the fear of contributing to a later inflationary situation; in other words, by bringing in additional credit and liquidity and resources it can be troublesome later on. Is this an important thing in your view?

MR. RASMINSKY: If by the --

COMMISSIONER GIBSON: This is again referring to the question of how far you can pursue an expansive policy without getting into trouble from the price point of view.

MR. RASMINSKY: Yes. I can conceive that this would be a consideration that the central bank

would have in mind, that in a situation of recession where public policy was directed to influence credit conditions in a way that would increase total demand, that you would have a combination of fiscal policy and monetary policy which led to a good deal of liquidity in the public sector and in the banking system.

I can conceive that if the central bank were completely confident that when the pendulum had swung in the other direction and there was pressure on demand, that fiscal policy would also swing in the other direction, so that there would be surpluses, budgetary surpluses available to mop up the excess liquidity. I can conceive that the central bank's appreciation of the likelihood of that happening would be a factor that affected the degree of monetary ease, the extent of the liquidity created during the recessionary phase. I wouldn't put this forward as necessarily a major factor, but I can imagine that there could be a situation where, if the central bank felt the task was going to be too difficult on the fiscal side, that it would be less inclined to encourage very easy conditions on the monetary side than if it had a greater confidence. This paragraph was not based, I may say, on actual experience; it is a theoretical paragraph and it is put in as an illustration of one of the limitations of monetary policy.

COMMISSIONER GIBSON: And this means you depend very much on the responsiveness or the central bank's assessment of the responsiveness and effectiveness of fiscal policy?

MR. RASMINSKY: That is the point, yes.

COMMISSIONER GIBSON: I would like to ask you a question or two about growth as an objective, and again returning to your basic objectives, the first one was sustained economic growth and high levels of employment efficiency, and you also talk about high employment. Now, is there anything special about growth as an objective over and above maintaining a reasonable level of utilization of a country's resources of people and productive equipment?

MR. RASMINSKY: Yes, I think that growth is full employment plus efficiency. What is special about growth as distinct from the other objectives is, I think, that it introduces the idea of productivity of efficiency. You could attain full employment if that was all you were interested in -- and I do not recommend this as a course of action -- by having half the population dig ditches and the other half fill them up again, but you certainly would not attain growth.

COMMISSIONER MACKINTOSH: How would you provide for a coffee break?

MR. RASMINSKY: I think this is a good time for it.

I think, Mr. Gibson, this is really the difference between the two concepts. In a sense, the limitations on growth are the additions to your labour force and productivity. Your growth objective is, I think, the sum of these two things; firstly, to have your labour force fully employed, and, secondly, to have it employed in a way which per unit of labour used increases over time the output of goods and services.

COMMISSIONER GIBSON: I understand the theory of this. Is there any help you can give us in translating it into something a little more concrete? How do we look at this? Is there any way of measuring it, or is it just a broad judgment of the general situation?

MR. RASMINSKY: Of course, we have been

looking at this for years and years. The growth objective has become much talked about as a popular objective of economic policy, and I think it is a good thing that it has.

COMMISSIONER GIBSON: But it is quite frequently mixed up in discussions with full employment, is it not?

MR. RASMINSKY: Yes, it is. I think the reason why people talk about growth now -- well, there is a variety of reasons, and one of them is the concentration of interest on the experience of underdeveloped countries which want to emerge from relatively primitive economies into expanding and more sophisticated economies. I think the concentration on this term "growth" results partly from the degree of centralized forward-looking planning, indicative or otherwise, that has taken place in Europe in recent years. But, I suppose all through our history the opening up of the country has been an exercise in growth.

COMMISSIONER GIBSON: I was going to ask you if you thought it had any special connotation for a young country -- that is, this objective?

MR. RASMINSKY: For a young country the growth connotation is partly the development of your basic economic resources, and the utilization of the opportunities that you have.

COMMISSIONER MACKINTOSH: Is there not a much more elementary reason for public interest in

this objective, namely, that for a few years the growth stopped?

MR. RASMINSKY: And so people were interested in it? Yes. Of course, the reason why people are interested in growth is that basically the community wants a higher standard of living, and the component of the higher standard of living -- what produces the higher standard of living -- is the employment of any unemployed resources that you have plus an increase in productivity. One comes back, I think, to those two elements of growth.

COMMISSIONER GIBSON: Is not growth synonymous with the idea of opportunity for individuals?

MR. RASMINSKY: Opportunity for employment in order to become producing members of the labour force.

COMMISSIONER GIBSON: Yes, and in business affairs as well.

MR. RASMINSKY: Yes. Of course, growth is not by any means growth as measured by the statisticians. It is not by any means necessarily synonymous with welfare. Growth is measured by the increase in the Gross National Product per head, or in the aggregate from year to year. It measures the goods and services that are produced, but it does not measure the goods and services that are not produced and which people may prefer to those that are produced.

One is leisure time. For example, there

are choices between the output of goods and the length of the working week, and if people want to have a shorter working week this will naturally have an effect on the measure of growth, although the extra day off may increase their welfare.

The difference between welfare and growth is also illustrated in the combination or in the structure of goods produced. You could have high growth rates as conventionally measured producing a lot of things that do not particularly add to welfare. During the war, for example, I suppose that the production of goods for destruction resulted in high growth rates, but certainly not in greater welfare.

Growth, as conventionally measured, is also affected by the choice of things that the community chooses to produce. If you put a lot of resources, for example, into education or into schools instead of into the output of goods, on the conventional measure of growth rates this may have the effect of producing a smaller growth rate and yet it certainly would not be adding to the immediate or the short-run welfare of the community.

COMMISSIONER GIBSON: I have heard it said that growth as an objective implies a sort of continuing active interest in the underlying developments in the economy as opposed to the shorter range changes in employment and price levels.

MR. RASMINSKY: I think that is very true, Mr. Gibson. I think that this results from

the addition of this element of efficiency of productivity; of making the best use that you can of your resources.

COMMISSIONER GIBSON: It has been suggested that it might be -- this does not apply to the Bank of Canada in particular; it is an idea that applies to any central bank -- helpful if central banks could make more precise and detailed statements of their policy objectives at any given time, or from time to time, citing specifically what sort of objectives they have in mind in terms of employment and in terms of prices; in other words, stating why they were pursuing a specific policy, and relating it quite directly to objectives. I do not know how often this could be done, but it might be done whenever there was any important change in policy, or it might be done at some periodic interval such as every quarter or half year. What do you think of this idea? I would like to hear your comments upon it.

MR. RASMINSKY: Our objectives are eternal! They do not change.

COMMISSIONER GIBSON: But you will not write down specifically what they are.

COMMISSIONER MACKINTOSH: Your methods are extremely temporal.

MR. RASMINSKY: Yes, our methods are temporal.

Mr. Gibson, did I understand your question correctly to mean that the central bank should

from time to time try to formulate more precisely than we have done, say in this submission ---

COMMISSIONER GIBSON: --- or in your past activities.

MR. RASMINSKY: --- what objectives it is pursuing in terms of employment goals and in terms of price goals?

COMMISSIONER GIBSON: Yes; price goals, for instance.

MR. RASMINSKY: Of course, objectives are forward-looking, and apart from the difficulty of foreseeing the future, which is probably not confined to central banks but which one certainly finds there, there is also the difficulty of guarantee-ing results. If you state what your objectives are, there really is no assurance at all. All you can control in the central bank is one particular seg-ment of the public policies, and even public policies as a whole are not the only operative forces in the economy, so there is no way by which the central bank could have any assurance that it would be able, through its actions, to achieve precisely formulated objectives in terms of employment goals or in terms of growth rates, or in terms of price levels.

COMMISSIONER GIBSON: Yes, I recognize that you could not be at all sure whether you would be successful or not, and, indeed, a large area of the policy is not within your purview. Nevertheless, the argument is that by a more precise statement of what you are hoping will be achieved in various cir-

cumstances would assist the community in understanding what is going on, and it could either be with you or against you, and that that might be helpful. I am not advocating this; I am just asking about it.

MR. RASMINSKY: The field in which the central bank might exercise, and does exercise, some influence is that of credit conditions, and an attempt to state precise objectives there, could, of course, lead to -- I suppose it would lead immediately to -- market action to move towards the type of credit conditions indicated so precisely by the central bank, and that might be quite misleading at times because a merit of monetary policy is that it has some flexibility; that it can adapt itself to changing situations, and it proceeds by a process of testing and probing. I think it would be a mistake on the part of the central bank to be too precise in its formulation of objectives.

Having said that I think that the central bank might do a fair amount by way of explanation of past policies and by way of explanation of changes in policy as it goes along. That we have tried to do - perhaps not to the extent that we would hope over time - to increase the amount of information we put out through our annual reports, and through statements such as those that have been made recently when there have been various specific acts in respect of monetary policy.

I am thinking, for example, of changes in the bank rate. But, such statements, in the nature of things, it seems to me, are always found to be backward rather than forward-looking.

COMMISSIONER GIBSON: Those are all the questions I have in this area, Mr. Chairman. Perhaps the other Commissioners have questions.

THE CHAIRMAN: There is a question I would like to ask. You said in your statement this morning that economic management is rarely confronted in normal peacetime circumstances with the necessity of combatting both substantial under-employment and substantial upward pressure on the price level at one and the same time.

I am not going to ask you to define what you mean by "normal peacetime circumstances" in the conditions under which we live. I just want to make it clear in my own mind what you mean by this paragraph in which you went on to say that if there was a rise in prices -- I am paraphrasing -- we should then look at the market imperfections to inquire as to whether they might have been the cause of the inflationary pressure.

Is the thought you were expressing there simply this, that inflation is merely a symptom of something; that it might be a symptom of certain market imperfections, and that we have to look at those imperfections in order to attain the desirable end of price stability? I do not know whether I have expressed myself clearly, or not.

MR. RASMINSKY: Yes, I think that is right, Mr. Chairman. I am trying to say two things here. First of all, dealing with this question of the possible conflict between price stability and the achievement of the other objectives, employment and growth, what I am saying is that you can consider two cases. There is the case, first of all, where the economy is overloaded, or where the economy is trying to do too much. That is the cause of generalized inflationary pressure on the economy. In that case I say there is really a false conflict between these two objectives because you cannot get any more out of the economy anyway under the assumption that I have made, namely, that the economy is, indeed, overloaded. The only ~~other~~ things that you can get, if you put additional pressure from the demand side on the economy, are further price increases or balance of payments troubles, and we do not want those.

However, I go on to say that a situation may arise in which, without there being this generalized excess demand on the economy, you nevertheless have price increases.

The constructive reaction to that situation is not to try to deal with it through the demand side or to push straight ahead beyond the point where you are overloading the economy; the constructive reaction to that situation is to look at the price increases themselves and ask why these prices are going up since, by hypothesis, they are not going up on account of an excess demand.

That type of situation has been pulled together, the variety of situations that may be involved there has been pulled together under this rather general term of market imperfections.

THE CHAIRMAN: I understand that.

COMMISSIONER LEMAN: Mr. Chairman, I should like to ask Mr. Rasminsky something arising from his comments on the merits of price stability.

Mr. Rasminsky, does part of your conviction about the value of price stability stem from a conviction that since prices must be adjusted all the time we never have a perfect price structure and they must be adjusted once in a while one against the other, that that process of adjustment will take place easier in a stationary price structure than in a moving type price structure? Do you think that the adjustment will be easier if the general level does not change?

MR. RASMINSKY: No, that was not the thought

I had in mind, Mr. Leman. Really, the basic thought that I had in mind has two strands to it. The first is that price stability is an accepted goal, setting aside the problem of what you mean by price stability, which we talked about before, and secondly, that the performance of the economy will be better under a situation where the value of money is stable than it will be in a situation where the value of money is changing.

You have raised the point that one of the reasons the performance of the economy will be better is that your relative price movements will produce more desirable consequences in shifting resources around if one does not have to have a depreciation of the value of money or a general change in the price level to contend with, and, on the face of it I think that this may well be the case. However, I have to say that it is not the proposition I had in mind.

COMMISSIONER LEMAN: But is it arguable whether this process of adjustment would be easier and smoother under one set of circumstances than under the other? Is it arguable that perhaps the adjustment might be easier in a flowing type of general price level than in a stationary one?

MR. RASMINSKY: It is arguable. I should like to hear what the argument is.

COMMISSIONER LEMAN: Well, really, the second question I was going to ask you was this. If you believe that monetary policy can have some direct effect towards the objective of price stability, is it

also possible that this action would at the same time impede to a certain extent this process of adjustment?

MR. RASMINSKY: I do not see why it should, Mr. Leman. I do not see why the expectation on the part of businessmen of a reasonable degree of stability in the general level of the prices, while leaving scope for the adjustment of individual prices -- I do not see why that should be a worse expectation, a worse hypothesis, for them to work on than the expectation of a continual increase in the price level involving, as it is bound to do if it persists, continual demands on the part of the community to protect themselves against that, and to retain their share of output by pushing up costs.

COMMISSIONER LEMAN: Are you suggesting that the only way monetary policy acts or performs in this field is through expectations?

MR. RASMINSKY: It is not the only way, no, sir.

COMMISSIONER LEMAN: Therefore, what I meant to ask -- and perhaps I did not express it properly -- is that whatever action monetary policy does take to attain price stability, could it be that at the same time to a certain extent it would impede the process of adjustment of relative prices? It is a hypothesis and I am just asking you if it is possible it may be so.

MR. RASMINSKY: I think that the only way I could answer that question is to say that I see no reason why the process of relative price movements should be imp-ded by policies that are directed towards

the attainment of the over-all objectives of the community, including price stability.

COMMISSIONER MACKINTOSH: There is this, Mr. Rasminsky, that I think downward movements of prices and incomes are more sluggish than upward movements, and if you have a general upward movement, the differentials between the sluggish or stagnant sectors in your economy and those that are more buoyant, will be increased, but that is apt to be a costly process and if you can substitute something else for it I would agree it would be more desirable; but hypothetically I do think that, as I say, these differentials between the more sluggish and the more buoyant elements of an economy with unused resources have been increased by periods of price rises, but the further you have to go in that the more costly it becomes, and perhaps the greater the later, deferred, costs will be.

MR. RASMINSKY: Yes, I see. Well, really, what it comes to is that one starts from the proposition that there are certain rigidities, imperfections in the price system, and these rigidities or imperfections will have a bearing on the movement of relative prices and it is easier to deal with them by putting them on the side, so to speak, with a rising price structure.

As a proposition I think that is arguable, but I would agree that the costs of such a policy are very considerable and that the more constructive attitude in the matter would be to deal with the rigidities themselves and endeavour to have a more free-operating price system.

COMMISSIONER MACKINTOSH: I do not think we should blink the fact or try to explain it away, the hypothetical fact, which I think is a fact, that one of the most ruthless and costly but most effective ways of wiping out all sorts of structural and institutional obstacles to change has been inflation. It has been highly effective at times but it has been enormously costly and unacceptably ruthless.

MR. RASMINSKY:
Let us not talk about inflation, but think of price increases as a technique for escaping from these rigidities, something that one would do year after year to the extent that people would get to know about it and accept it. People are not all that unsophisticated or foolish, and they will take steps to protect themselves against it. The value that you achieve through this process will be, in my judgment, lost.

COMMISSIONER MACKINTOSH: Is it not a proper and practical view that in an upturn of an economy from a recession, with the best forecasting and the most efficient means, you will not avoid some increase in prices and that therefore it is a proper view for the central bank to take that it must avoid as much as possible. It need not really concern itself much with the theoretical situation of how advantageous it would be to have none at all, for in fact you won't ever have that.
Prices act a bit like interest rates and when they get a bit tight they all close up, and when there is

some slack the consumer prices may not drop much but various sectors of prices sag down.

I do not think you can avoid some price increases if you have a strong upturn. The thing is to avoid those that would carry on and create future problems.

MR. RASMINSKY: I should like to make two comments on that, Dr. Mackintosh. I would accept the formulation that you make that the central bank should seek to avoid as much price increase as possible, but that leaves open the question as to what is possible consistent with the other objectives.

In the situation which you have described of recovery from a recession, a strong upturn in business, you are by hypothesis taking a situation where there is a good deal of slack in the economy and a good deal or large amounts of unused resources, and I would not be prepared to say that in that situation the central bank or anybody else for that matter should have a complacent view towards an upturn in prices.

I do not think that an upturn in prices in those circumstances is a necessary part of public policies that are directed towards overcoming the recession and increasing levels of employment and output in the country.

THE CHAIRMAN: We shall adjourn now until 2.15 p.m. Will that give you sufficient time, Mr. Rasminsky?

MR. RASMINSKY: Yes, that is quite satisfactory.

--- On resuming at 2.15 p.m.

THE CHAIRMAN: We will now resume.

COMMISSIONER BROWN: May I ask a couple of questions to finish off what we were dealing with this morning, by way of some small points for further elucidation?

We had considerable discussion about the matter of price stability, and some mention was made of the extent to which general price movements in this country would be influenced by price changes in other countries, particularly with a fixed rate of exchange. In your introductory remarks this morning, Mr. Rasminsky, you pointed out the problems that would exist if a persistent inflationary price change took place in this country as against that in our principal trading partners.

Now, does the same problem hold if the opposite takes place? In other words, if our principal trading partners experience a persistent inflationary period, in view of our trading position, can we offset this in part by monetary policy? In other words, can we take advantage of that situation, and to that extent not import the price increases?

MR. RASMINSKY: I think that would be a very difficult situation, Mr. Brown. If I understood your question correctly, might I rephrase it in this way. If under fixed rate conditions we make a better job of managing our affairs here, so that we do not generate any appreciable inflation domestically,

but our principal trading partners do not do as well, and consequently their prices go up, and prices of our imports converted at a fixed rate of exchange go up, is it possible that monetary policy here can be directed to producing sufficient compensatory decline in domestically consumed goods to stabilize the price level as a whole? Have I understood your question correctly?

COMMISSIONER BROWN: I did not anticipate that we would be able to stabilize it as a whole, but certainly to affect the external pressures.

MR. RASMINSKY: If you put the question in that way, the effect of the situation that you describe would be that the price of imported goods would rise relatively to the price of domestically produced goods. The demand in foreign countries under these inflationary conditions that you have postulated would be high. Our balance of payments would tend to move into a surplus position. There would be an inflow of foreign exchange into the country which would require to be financed, and the financing of that inflow of foreign exchange could produce, depending on how it was financed, an increase in the amount of liquidity in the country, which would have the effect of bringing some upward pressure to bear on price levels here, though perhaps not as much as abroad.

There are some fairly recent examples of the sort of thing that you have in mind which occurred to me. One thinks of our own situation back in 1946.

Under fixed rate conditions we were confronted with a very considerable inflow of exchange at a time when prices abroad were rising quite rapidly, partly as a result of the termination of price controls in the United States. That situation seemed to be of a character where the objective of trying to maintain a reasonable degree of price stability, or a lesser degree of price rise, involved upward revaluation in the exchange value of the Canadian dollar.

Another example of the sort that you may have in mind, and that comes to my mind, is that of Germany. The Germans on the whole were more successful than other people in containing demand pressures, or increasing their output, or the amount of resources they had to work with. Part of the influx of exchange was due to that reason, and part of it was due to capital transfers.

The Germans did not want to give up the objective of price stability, and as a result they made a minor upward revaluation in the fixed value of their currency, with the objective of trying to contain their domestic inflationary pressures for stopping the capital inflow. As time went on they reached the conclusion that they could not hold out against these external influences, and apparently they have taken the other tack of allowing their prices and costs to go up, as part of a process of international adjustment.

Under the conditions you mention, I think we could have some hope of doing somewhat better than

other countries, but if the movements were very large the likelihood would seem to me to raise the question in our minds as to whether the exchange value of the Canadian dollar was appropriate, or whether it should be adjusted upwards.

COMMISSIONER BROWN: That was what I wanted to get, whether in your opinion it was the converse of the problem postulated in your introductory remarks. I gather from your answer that you regard it as such.

MR. RASMINSKY: I regard the exchange value as being connected with this problem, yes.

COMMISSIONER BROWN: Following along the same thought to some degree, you mention in both places the maintenance of a sound external financial position as being one of the objectives. I suppose in some degree that could be further refined now to the maintenance of the 92½ cent parity. You bring out in paragraph 71 of your second section that this, as an objective, places certain limitations, or has implications for other uses of monetary policy.

I assume that this is in the context of monetary policy in other countries remaining constant. Or, can I put it this way: does this have any further implications in the sense of possibly tying monetary policies in this country to changes in monetary policies in other countries?

MR. RASMINSKY: I would not think of it in that way, Mr. Brown. I think that under any exchange rate system, whether it is a fixed rate or

a fluctuating rate, that (a) the policy of the country including the monetary policy has to have regard to the country's international position, to its balance of payments, to the state of its international transactions; and I think (b) that a country cannot fail to be concerned with the level of its exchange rate, regardless of the system which is in force at that moment.

I think that the exchange rate is too important in the economy for the public authorities to look away from it and to be unconcerned with what is the value of the exchange rate. In that respect I do not think that the question is one of black and white as between a fluctuating rate system and a fixed rate system.

COMMISSIONER BROWN: Would you like to carry on and deal with the second part -- in view of the fairly open economy that we have, because of the very things that you have enumerated, are the monetary policies being followed in Canada -- to what extent will they or will they not be affected by monetary policies of other countries?

MR. RASMINSKY: I don't think there is any question that the impact of monetary conditions, and economic conditions, elsewhere has an influence on the Canadian economy, and has an influence on public policies generally, including monetary policies. But I do not think it follows from that, that monetary policy in Canada is in a complete straitjacket and has no freedom of action at all.

I think the basis for such a view might be if one thought that the protection of the external value of the Canadian dollar was entirely dependent upon producing through variations in the interest rate just enough flow of external capital to balance the current account, and that this was the only thing that monetary policy could take into account and the only way of having an adequate inflow of foreign capital.

The fact of the matter is that neither of those propositions is true, although it is clearly the case that interest rates do influence external capital. A lot of international capital movements are not particularly sensitive to interest rates, and consequently the movement in the interest rate is not the mechanism by which such capital movements could be controlled.

I think, for example, that the flow of direct investment, which amounts in this country to perhaps $400 million or $500 million a year, is not particularly sensitive to the movements in the interest rate. Of course a lot in this connection depends on what is the size of the current account deficit. If the current account deficit is so large that very significant inflows of capital of a type produced by interest rate differentials are needed, then it must be a major objective of monetary policy to set out to protect the external value of the Canadian dollar to produce enough inflows of that type.

On the other side, there is the question of how much leeway monetary policy has. Of course, there is the leeway provided by fluctuations in reserves, which I referred to this morning.

So, in this connection there are certain peculiarities about our position: the flow of short-term capital, the exposure which is unusually large. However, I think that every country in determining its monetary policy has to take into account -- and I include the United States, powerful though it is -- what are the appropriate credit conditions from time to time. It has to take into account the external factors and the need to protect whatever exchange rate the public authorities at the time decide is the appropriate one for that country.

COMMISSIONER GIBSON: I have one or two more questions in the area of objectives and policy mix. At the beginning of the chapter on the role of monetary policy -- that is Paper No. 2 -- you state that the broad objectives of monetary policy are those of public economic policy generally, and you talk about what they are.

COMMISSIONER GIBSON: In paragraph 10 in the same section you go on to say:

> "But in the final analysis it must take the Government's expenditure, taxation and debt management policies as given (even though it may be trying in private to persuade the Government to change one or more of these policies) and must follow the monetary policy which, in these circumstances and having regard to the over-all economic situation, seems the most appropriate. Its field of choice may be greatly restricted by the other policies being followed, since the central bank cannot base its own policy on objectives that differ in a major way from those on which other public financial policies are based, but it may on occasion have to be influenced by its view of the speed with which the latter will be adapted to the changing requirements of the over-all economic situation."

Now, there is a contrast here between the statement at the beginning that the objectives are those of public policy generally and the statements here that there may be differences. Does that mean there may be differences in objectives, differences in interpretation of how to achieve the objectives, differences in the priorities in objectives; will you talk a little more about this?

MR. RASMINSKY: I would like to say to begin with that if I had my life to live over again this

sentence would have been drafted differently. In the drafting of this sentenee, the suggestion that the objectives cannot differ in a major way, does, as you say, suggest there may nevertheless be some minor differences in objectives.

COMMISSIONER GIBSON: Or differences in emphasis?

MR. RASMINSKY: Or differences in emphasis, yes. On the question of objectives, of course, in a sense "objectives" is a pleasant phrase, it is a good phrase to write about, but in actual life I don't start each business day by phoning over to the Minister of Finance and saying to him, "Good morning, Mr. Nowlan; I hope you had a good night's sleep. What are your objectives today?", and then tell him that in the tiniest degree my own objectives are different from his for that particular day.

I think the way it works is that there is a general consensus which is arrived at as a result of discussion, and which is arrived at really by the force of events as to what it is that you are trying to do, and in my judgment there can be no difference.

If there is a difference of objectives, then there is really a conflict of policy and in the ordinary course of events if a conflict of policy arises it has to be resolved, so there cannot be any continuing difference of objectives in that sense. But this doesn't mean that there is among those concerned a monolithic view as to what the precise facts of the situation are or as to the precise tactics that are involved in trying

to deal with those facts, and there might be occasions in which the central bank's appreciation was different -- if one got everybody's appreciation down in black and white -- it was a bit different as to facts and tactics.

Perhaps another way of saying this would be that the ultimate objectives must be the same but that as to what you are trying to do, what you have in mind for the situation in the next short period of time, on occasion there might be some differences in that, and if it turned out that these differences were really serious and affected the ultimate objectives, then you would have the conflict of policy situation that I mentioned before.

COMMISSIONER GIBSON: In other words, there can be significant differences in interpretation as to how to achieve objectives and in emphasis on particular objectives in time.

You say in paragraph 9, and this gets into the question of the mix of policy:

> "One of the important functions performed by the central bank is to influence the decisions which determine the 'mix' of policies in the financial and economic field."

Then you go on to say that the central bank should make known its views on the net balance of policies for the whole range of government economic policy, and you also say in paragraph 10, that it is necessary you should express those views even to the point of private 'nagging',

so that I take it you are saying that the process of arriving at appropriate policies to meet a set of objectives is a matter of opinion in which the central bank has a significant part in contributing to the development of policy?

MR. RASMINSKY: That is right, the central bank has a significant part in contributing to the development of policies, and there is room for differences of opinion as to the strategy that should be used over short periods of time in trying to attain those objectives.

COMMISSIONER GIBSON: We have heard quite a lot from central bankers and some from the people who are experts in the fiscal area, and we have noted a tendency for the experts in central banking to minimize the capacities of monetary policy, and the few experts we have had on fiscal policy minimize the possibilities of fiscal policy.

In thinking of this mix and advising on what appropriate other government policies ought to be pursued other than strictly monetary, have you any such bias, Mr. Rasminsky?

MR. RASMINSKY: How can I answer that! Well, the answer is no.

COMMISSIONER GIBSON: I didn't think you would answer the question. In paragraph 75 you do admit that monetary policy has quite an important part to play. I would like to ask you a bit, though, about how you think particularly debt management and fiscal policy fit into this blend of national economic policy. Do you feel that certain policies are appropriate to certain

objectives or that some were better at certain times than others? Is there, for example, the situation that arises occasionally where all you need is a change in monetary policy and the fiscal policy doesn't need to come into the picture? Could you talk about this question of blending policies a bit more?

MR. RASMINSKY: I don't know that I could say a great deal more then we have said in the submission, Mr. Gibson. I don't think of one policy as being directed more towards the accomplishment of one of the objectives than another. Of course, the thing that I am most concerned with is the mix, the thing that I am professionally most concerned with is the mix of fiscal policy and debt management policy and monetary policy. These can be combined to produce a certain state of credit conditions in the economy, a certain level of interest rates, a certain degree of availability of funds for investment spending and certain expectations on the part of business people and consumers.

The important thing to my mind is that they should know what they are doing; that those concerned should know what it is that they are aiming at and should work together so that an undue load does not fall on any one. It is easier to talk of this in terms of the limiting cases than it is in terms of intermediate cases.

In a case where the economy is overloaded, where there is a great deal of generalized demand pressure on resources, then clearly one wishes credit conditions to move in a direction

which will discourage spending in order to contain the pressure. That is clearly the situation, and one in which one would wish to have fiscal policy act in a way which exercises some restraining influence. If fiscal policy were to do this and at the same time monetary policy were to exercise the opposite influence, you would have a very uncertain and confused situation.

With fiscal policy acting in that way it must be supported by monetary policy, and vice versa, which would enable monetary policy to make a contribution within the range of the practical limitations that we have referred to here. It is not altogether clear in my mind where debt management fits into this in practice. It is clear enough in principle that debt management could help, but whether as a practical matter in the sort of situation that one is thinking about here, where there is a great demand for funds in the capital market for long-term investment, whether in fact the Government can change the structure of its debt to add to that demand by shifting from short maturities to long maturities is another question. You may not come up with the same answer to that as you came up with when you posed it as a question of principle.

At the other end of the spectrum, if the economy is underemployed, if there are lots of unused resources, then to the extent that the international situation permits, you want to see credit conditions of a character that encourages spending, with debt management policies and monetary policies that would increase the liquidity of the economy and

lead to a relatively low level of interest rates and high availability of credit.

In that situation it may be that fiscal policy -- and here I may be revealing some of the professional bias that you spoke of -- it may be that in that situation the impact on total spending of fiscal policy may be particularly important.

Those, I think, are the limiting cases. I think that one would have to appraise any of the intermediate cases in the light of all the circumstances at the time.

COMMISSIONER GIBSON: But you see these three avenues of economic policy working as much in harmony as possible; you don't see one offsetting the other. For instance, in this statement which you made this morning, I am a little puzzled by the statement that starts at the bottom of page 10 and goes over onto page 11 where you state -- and you were talking about the mix of public policies -- and you said:

> "With proper coordination, it can make an important contribution to the success of other public economic policies. For example, if an expansionary fiscal policy is appropriate in the economic circumstances, including the external financial position, then monetary policy coordinated with debt management policy may be able to prevent the increased borrowing requirements of the Government from producing inappropriate credit conditions."

You mean that we are in tune with the accepting of fiscal policy, or could it be overdone?

MR. RASMINSKY: The word "inappropriate" was carefully chosen, Mr. Gibson. I take it what surprised you ---

COMMISSIONER GIBSON: I am puzzled, I am not surprised! I just don't quite understand it.

MR. RASMINSKY: What puzzles you, Mr. Gibson, I take it is that we say:

> "if an expansionary fiscal policy is appropriate in the economic circumstances, then monetary policy coordinated with debt management policy may be able to prevent the increased borrowing requirements of the Government from producing ...."

And we say there "producing inappropriate credit conditions", and I take it you would have expected us to say there "producing restrictive credit conditions" or "a tightening in credit conditions"?

COMMISSIONER GIBSON: Yes.

MR. RASMINSKY: That I think would indeed be the normal case. The reason we didn't say that is that we were able to think of a case where "appropriate credit conditions" might involve some tightening in those circumstances.

COMMISSIONER GIBSON: It is a little offset here.

MR. RASMINSKY: Yes. At the present time, as I am sure you are aware, Mr. Gibson, there is considerable discussion in the United States regarding

the mix of their monetary, fiscal and debt management policies. As I understand the general philosophy that the Administration has been working on, up to the present or until fairly recently that philosophy has been that the basic objective should be to increase private investment in the United States in order to increase the productivity of the American economy, simultaneously increasing growth, with the expectation that the increase in productivity would be helpful to them in dealing with their balance of payments situation.

Recently there has been a great deal of discussion in the United States about the appropriate mix of policies. The mix of policies which is currently under discussion is one in which the stimulus to growth and stimulus to the expansion of the economy would be looked for in an increased budgetary deficit, and in which -- and I don't mean to suggest that this is the policy of the United States administration because I obviously have no basis for saying what the policy of the United States administration is, but this is what the views of some students of the United States economy are-- the mix would involve looking to an increased budgetary deficit for stimulus to growth and trying to deal with the balance of payments situation through discouraging capital outflows through a somewhat higher level of interest rates.

Now, I repeat I have no idea whether this is going to happen, but this is what some people think will happen. While having regard to the external situation, it is possible to conceive of a case in which the

appropriate credit conditions in the mix might be of that character, even at a time when there is a budgetary deficit.

COMMISSIONER GIBSON: Thank you very much. Those are all my questions in that area, Mr. Chairman.

COMMISSIONER LEMAN: I would like to go on to something that flows quite naturally from Mr. Gibson's questions, and to try to pin point a little bit some of your understanding of the effectiveness of monetary policy first.

To go back again to the reference which Mr. Gibson made to page 10 of this morning's statement you did express confidence in its value at the bottom of that page, where you say:

> "With proper coordination, it can make an important contribution to the suceess of other public economic policies."

A little higher up on that same page there is a sentence that I would like to quote:

> "Indeed, I believe one of the most important contributions that monetary policy can make is to help keep credit conditions within reasonable limits so that the economy will suffer from neither the periodic credit crises of earlier times on the one hand ..."

et cetera. That seems to be reinforced a bit on page 11. To me that suggests the value is in avoiding crises, or in avoiding great excesses in one way or another. On page 11 you say:

> "The empirical evidence regarding the strength of the impact of monetary policy over the short-run tends to be inconclusive ..."

And then you go on to explain why that is not surprising because of other factors.

Can you summarize briefly where you think monetary policy is effective and how, and state whether as a stabilizer it is not very effective, or is quite effective? Can you put some quantitative measures on this?

MR. RASMINSKY: I am afraid I could not put any quantitative measures on it, Mr. Leman. I would think of this as being in three compartments.

Firstly, I think that the contribution of monetary policy in keeping credit conditions within a tolerable range is of itself a very important contribution. The extreme credit crisis is obviously

something which it is important to avoid, and so is the loss of confidence in a market produced by excessive monetary expansion on the other side.

Secondly, I think that the effect of monetary policy in helping to produce and maintain a balanced external financial position is quantitatively very important, particularly, perhaps, in the short run. In the final analysis the whole range of public policies is what is involved in that.

The area of doubt relates to the third question of how important a contribution monetary policy can make in the short cycle as a stabilizing mechanism. Perhaps in this connection I should say that we should distinguish between monetary policy and credit conditions. Monetary policy may have to change a good deal to keep credit conditions from changing too much. So even if one has a relatively modest view as to the impact that credit conditions themselves have on the demand for goods and services, it still would be the case that there would be circumstances in which the central bank would have to work very hard in order to keep credit conditions from changing too abruptly in an inappropriate direction. Leaving that aside I would feel unable to put a figure on the way in which credit conditions affect the economy quantitatively.

As you know, and I am sure your staff knows much better than I do, there has been a fair

amount of empirical work done on this by the Oxford Institute of Statistics, and after that it was worked on by the Radcliffe Commission, and I believe your own staff has done some work too, the results of which have been rather inconclusive. One can think of certain fields in which spending decisions might be quite importantly influenced by credit conditions. One would expect them to be importantly influenced by credit conditions. I am thinking of fields involving the investment of funds over long periods of time, with long amortization periods, and it may be in those fields, such as housing and public utilities, that the effect of credit conditions is quite considerable. Other fields such as consumer spending, for example, seem to be rather insensitive to credit conditions.

I think the only conclusion that one can come to -- at least, the only conclusion that I have felt able to come to -- is that there is an influence; that the influence is strong enough to make one want to try very hard to operate in the right direction, but not strong enough to have a great deal of confidence in it as the ultimate stabilizer of the demand for goods.

COMMISSIONER LEMAN: Can you explore a little bit how you maintain it if you try very hard? You have said it is worth trying very hard, and at page 13 you even express confidence that it can serve even in the short-run objectives because you say:

"Even though the lag between the implementation of monetary policy and its effect on spending decisions may be fairly long, the length of the typical business cycle, particularly the expansionary phase, appears to me to be long enough to make it possible for our monetary policy to make a worthwhile contribution to stabilization."

First, there is a problem of the recognition of exactly at what point of the cycle one is. That is one difficulty, is it not? Then, if you have some doubts about the measureability of the impact of changes in credit conditions on the demand for goods and services, how does one resolve all these difficulties in managing this thing?

MR. RASMINSKY: I often wonder. You do the best you can, Mr. Leman. You form the best judgment that you can on the basis of the information available to you as to what the state of the economy is. There are occasions when that is not easy, but that is not always the case.

You often feel you do know what the state of the economy is. You watch the various economic and financial indicators that you regard as important. You watch your own level of interest rates. You watch other country's levels of interest rates, and the spread between yours and theirs. You watch the state of

the banking system and look to see what is happening to bank assets and bank liquidity. You watch what is happening to employment, to unemployment, to output, to prices, to imports and to exports, and you form the best judgment that you can as to what the state of the economy is, and the direction in which you think it is moving.

You look to see what the state of other public policies is, what the fiscal position is, what the debt management policies are, and you are continually prepared to revise your views as to what the state of the economy is and what the outlook is, and out of this amalgam of considerations you form some judgment as to the soundness, and as to the direction in which you would like to see credit conditions move. You form a judgment as to whether you think credit conditions should be becoming a bit easier or a bit tighter, having always in mind not only your domestic situation but also the international situation. Having formed that judgment, subject to change without notice, you take the action that is appropriate.

You are usually sure of the sign, so to speak, of the movement, and of the direction in which you want to move, and this, I think, enables monetary policy to make a contribution in combination with other policies towards achieving the objectives.

Although it would certainly be helpful to put arithmetic numbers on it, I do not think it is necessary to be able to do so in order to make a

contribution from the side of monetary policy.

COMMISSIONER LEMAN: Well, I presume that in performing this function one has to ask himself all the time: How far would this trend that I see go if I did not do anything? Is not that one of the questions?

MR. RASMINSKY: Yes. Monetary policy is quite frequently responsive to something that is going on outside.

COMMISSIONER LEMAN: But is that the answer -- I do not know. To know how far this would go if you did not do anything.

MR. RASMINSKY: That is right. The central bank is certainly not gifted with foresight that enables it to see what the future holds. All that it can do is form the best judgment it can, and continue to be prepared to revise its judgment in the light of new evidence.

COMMISSIONER LEMAN: In another sense, can we do anything by looking back in trying to get some measure of the effectiveness of the monetary policy by itself or together with other policies that were working at the time, and that were contributing? Can you pick some particular period in which the central bank was acting because it saw a certain set of conditions? Take a year like 1956, or some earlier year. Is it possible to measure how long it took to obtain the results or effects you hoped for?

MR. RASMINSKY: I do not think so, Mr.

Leman. The difficulty is that monetary policy never does operate by itself, and other circumstances are constantly changing. I think, as I believe I indicated in one of these papers, that the history of central banking in Canada is too short, and there are too many special periods in it, such as the war period, to permit of a statistical analysis that would set out the isolated effects of monetary policy, even if the facts permitted such an analysis to be made. We have not tried to do that.

As to picking a particular period where monetary policy had some effect, I might mention that there is a recent period in which monetary policy in conjunction with other government policies had certain and specific objectives of a pretty clearly formulated type in mind, and where monetary policy, I think it was demonstrated, had some effectiveness. I am referring to the summer of 1962 when there was a clear objective in the minds of the public authorities to restore balance to our international accounts, and restore the depleted reserves.

At that time, monetary policy, in conjunction with other public policies, was helpful in producing a set of credit conditions which were one of the factors bringing the exchange drain to an end and producing an inflow. So, there was a clearly definite objective in mind, and I think that one would say that without a very significant time lapse the public policy was successful in attaining those objectives.

COMMISSIONER LEMAN: And it acted fairly quickly in that case. But, in paragraph 17 of Submission II you refer to the fact that there are ---

MR. RASMINSKY: To which paragraph are you referring, Mr. Leman?

COMMISSIONER LEMAN: Paragraph 17 of Submission II. There you refer to the fact that there are two forces that work all the time; one is the cost of credit -- I am trying to get a more precise idea of what you call changes in credit conditions here -- and the other is its availability. A little later on in paragraph 19 you say:

> "While small changes in credit conditions might have only a small impact on the level of demand for goods and services, it is also no doubt the case that large changes in credit conditions have a large impact on demand."

Now, how would you define a small change in credit conditions as opposed to a large change? Would you describe the kind of change that makes itself felt through the availability of credit as a large change, and would you describe a small change as one that only affects the cost of credit within smaller limits? Is that about the difference between the two -- between a small change and a large change?

MR. RASMINSKY: No, I do not think so, Mr. Leman. I think that changes in the cost of credit are quite likely to be accompanied before very

long by changes in availability. That is, as credit becomes cheaper it is also likely to become more easily available. Markets work that way.

Certainly, if you have very substantial changes in the cost of credit you are bound to have, through the imperfections of the market, at least temporary changes in the availability of credit, but in talking about small changes and large changes we did not have in mind the distinction between costs and availability.

But we had, rather, quantitative considerations in mind related to levels of interest rates and associated changes in availability.

COMMISSIONER LEMAN: If we have some doubts about the responsiveness of various borrowers in the country to changes in cost of money, I imagine we have no doubts that availability acts in a strong way when you have such sharp changes, that availability is affected to the point of having the equivalent of a rationing system in the process. Is that correct?

MR. RASMINSKY: Yes. Of course, the distinction between cost and availability is really a measure of the market imperfection. In a perfect market there would be no distinction, I would take it, between these two concepts of cost and availability, but markets are not perfect. It is the case that if you have sharp increases in the cost of credit you will have various rationing effects, stiffening of the terms of credit, and so on, which have an impact.

I do not think that these rationing effects are ultimately the things which one looks to, because ultimately the markets will find a way. Markets will not accept the imperfections. They will find a way of making funds available, even though they are temporarily clogged up in the normal channels from which one would have expected to get credit.

COMMISSIONER LEMAN: Does this process work differently, according to what you are trying to accomplish? Do you subscribe to the views of some people that the effectiveness of the policy is greater

in a contractionary sense than it is in an expansionary sense or is it about equal either way?

MR. RASMINSKY: I think that what is likely to affect the impact of changed credit conditions is the view that is taken by the business community about business prospects. I think that this plays a very important part in determining the apparent successes or otherwise of monetary policy in producing changes in credit conditions. I should like to develop a certain point here. In a situation of deep depression the views of business prospects may be so poor that a very large increase in the amount of liquidity in the economy, a very great easing of credit conditions, increase in availability, may have little effect. At the other end of the scale, in a time of boom the view of business prospects may be so good that even very tight credit conditions within the range of what is feasible may have little effect, but if one isolates from this notion of business prospects, I would see no reason for not expecting symmetry. I would see no reason for feeling that credit conditions are more effective in restraining a boom than in encouraging a revival of activity in the event of a recession.

--- Short recess.

COMMISSIONER LEMAN: Mr. Rasminsky, I wonder if we could go back to the last question we discussed, for I am not sure if I understood clearly what you told us. The question was: is the effectiveness of monetary policy, the way you have described in your submission it

should work, more effective in a contractionary sense than in an expansionery sense? Is there a difference between the two? Do you feel more confident that you can obtain results in restraining things during a boom than in "revving" things up during a recession?

MR. RASMINSKY: I am not confident that monetary policy by itself can do either of these things, Mr. Leman. That, I think, is the thread which runs throughout our whole submission, and my statement this morning, that the importance and effectiveness of monetary policy is as part of a package of public policies which is directed towards certain things.

Furthermore, in thinking of the effectiveness of monetary policy in a boom situation or in a recession situation, I have been thinking of it, and do think of it, within the limits which -- and I may as well say right now I am not going to be able to be completely precise about this -- I conceive that it is practicable to use this instrument to tighten or to loosen credit conditions. If it were not for that limitation of practicability, I think that I would urge the conclusion that monetary policy is more likely to be effective in restraining an expansion then it is in encouraging an expansion at the other end of the spectrum, for there is theoretically no limit to the tightness that could be permitted or produced by monetary policy, and certainly one way to bring an expansion to an end would be to permit or to encourage a credit crisis to develop. But I rule that out of the question.

However, if it were not for that sort of

consideration, monetary policy might be more effective in restraining an expansion than in encouraging the revival of activity because on that side, on the side of encouraging a revival of activity, you can lead a horse to water but you do not necessarily find yourself in a position where you can make him drink, and no matter how much money an ill-advised central bank might flood the country with, there is no guarantee that the money will be spent in any brief period of time.

We have had some experience, not recently but going back to the early 1930's, with that fact. If one introduces the concept of reasonable limits and if one does not make any particular assumption about business psychology, then I think that I would have to go back to the same answer I gave before, Mr. Leman, that I would see no a priori reason why within the limits of practicality and in combination with other policies, variations in credit conditions should not be just about as helpful in encouraging an expansion that you want than they are in discouraging excessive demand at the other end of the scale.

COMMISSIONER LEMAN: But one cannot abstract from their effect on business expectations, can one?

MR. RASMINSKY: No; business expectations are always, I agree, a very important element in the situation. Business expectations, of course, are affected by things other than monetary policy.

COMMISSIONER MACKINTOSH: Are there not a couple of points missing in a plain explanation, namely, that as you say, there is no limit to the tightness

which you can create and that this, in what we assume is the top of an excessive boom, destroys the expectations of the continuation of this violent activity, and that is not too difficult to do.

When you come to the bottom of severe depression it is not merely making credit available to applicants at low rates, it is a series of processes by which un-creditworthy applicants are turned into creditworthy applicants, and that takes more than monetary policy and it can be a peculiarly stubborn problem. The banks, even in depression, have lots of applicants but very few of them are creditworthy.

MR. RASMINSKY: I think there is a lot in that, Dr. Mackintosh. I think if the sort of condition you have in mind were persisted in for long enough, monetary expansion on the large and sustained scale could, after perhaps a considerable time lag, produce such a revival of demand that you would get a boom. I am not saying it is necessarily a desirable thing to do, but I take it Mr. Leman's question was concerned with the subject of lags, with the time involved in these processes.

COMMISSIONER LEMAN: Yes, I did have the lags in mind in part because there is not only the effectiveness from the point of view of the capacity to achieve results in the absolute, but the time it takes to achieve them. That is a second consideration, but I am just a little worried about the fact that we keep talking about the policy mix, fiscal policy, debt management policy, and monetary policy, and that we have

to remain so vague about the capacity of each one of them to achieve that part of the result that is wanted. That is what worries me.

MR. RASMINSKY: Well, it is a worry. It certainly would be a more satisfactory state of affairs if we could be more precise on these things; meanwhile, it is something to at least be sure of the direction in which you want to move and by a process of testing and probing to do what you can to produce credit conditions which will affect spending decisions so that the economy does move in that direction.

I would take the implication of your worry, Mr. Leman, to be that it would be a very desirable thing to have more statistical information, more concrete knowledge of the basic flow of funds through the economy than we have, to be able to measure some of these impacts, and the Bank of Canada is making some worthwhile contributions, I would hope, to this process of increasing our knowledge.

COMMISSIONER LEMAN: So that part of the difficulty now is lack of information, and you do feel that there is an improvement that can be brought about in supplying the necessary information that would be required to help the effectiveness of monetary policy or at least to help in its management, let us say?

MR. RASMINSKY: To help in the management of public policies generally, including monetary policy.

Yes, I think there is a lot of scope for improvement here. Generally we feel in the Bank that

the state of economic information in Canada, as compared with other countries, is really quite good. The Bank, incidentally, has no statutory power to collect statistics. Any statistical information that is furnished to us is furnished to us voluntarily.

We do get a fair amount of information from the chartered banks and other financial institutions on this voluntary basis, but we acquire most of our statistical information from the Dominion Bureau of Statistics. In our opinion the Bureau is doing a very good job in this field, and we maintain a close contact with that organization. As I have indicated, however, there is always room for improvement, but at a cost, of course.

The fact that our economy is so much smaller than, say, the United States economy does not proportionately reduce the cost of collecting this information, but it is our opinion that the importance of getting information is great enough to justify the investment of a good deal of resources in this.

I may say that from our point of view one of the most valuable improvements which could be made in the sources of information now available would be to reduce the time lag with which information is available. For example, at the present time the most recent figure for the index of industrial production relates to October; the most recent figure for both exports and imports relates to October, and due to some turnover in the system that they are using in the Dominion Bureau of Statistics the most recent month for

which commodity detail is available on imports is for the month of June.

The most recent quarter for which balance of payments statistics are available is the third quarter of the year, and apart from these lags there are serious gaps in our information.

For example, we don't have a quarterly survey of investment intentions, which would be valuable. We don't have, as some other countries have, quarterly balance sheet information on the various sectors of the economy, including financial corporations other than banks and non-financial corporations. I think in all these respects the situation could provide better ground work for the sort of empirical investigation you have in mind.

In referring to the lags in information I want to repeat what I said before, that I think the Dominion Bureau of Statistics is doing an excellent job under difficult circumstances relating to the numbers of their staff, among other things. Skills required for a job of this sort are extremely high, and I think there is very general admiration, not only in Canada but in other countries, for the quality of the output of the Dominion Bureau of Statistics. So, I don't want what I have said to appear in any sense to be critical of the Bureau, who are in fact doing an excellent job.

COMMISSIONER LEMAN: In order to get a clearer idea of what the lags are, Mr. Rasminsky, could we go through the process a bit?

On page 8 of your statement this morning you describe very briefly your view of how monetary policy operates. You say you believe changes in credit conditions have an influence on demands for goods and services and the flow of capital in and out of Canada. Then you go on to say that

normally this operates through changes in assets of the chartered banks and the money supply, and can have an important influence on credit conditions generally. That is the way your brief describes the workings of the monetary policy. I would like to ask how this process ends up by influencing the demand for goods and services? Could you tell us how it works? It is not just the fact that bank loans are a little higher or a little lower that necessarily will give you all the effect relative to the demand for goods and services. How does the whole spectrum of business expectancies get influenced in the end?

MR. RASMINSKY: Mr. Leman, the question of the way in which credit conditions operate on the demand for goods and services is dealt with in paragraphs 11 to 20 of the submission. I don't know that I could with justice to our submission try to compress it into a single sentence. If I were to attempt to do so, I would say, this is the way we look at it -- and as I indicated this morning, it is one way of looking at it.

Individuals and corporations in the economy have a choice at any given moment of time as to whether to spend their money, which would result in a change in the demand for goods or services, or not to spend. They make the decision as to whether they will spend or not spend on goods and services. The alternative to spending on goods and services is to improve their financial position,

so to speak, by acquiring financial assets or discharging financial liabilities.

This decision to spend or not to spend is effected by the rewards and penalties that are involved in not spending. These rewards and penalties are measured by the rates of interest available on financial assets, by the cost of borrowing, by the associated changes in the availability of credit, by the ease or otherwise of borrowing, or what one might call the non-price factors connected with borrowing.

This is the broad mechanism by which we think credit conditions exercise an influence over the demand for goods and services.

COMMISSIONER LEMAN: I have read the whole submission very carefully, Mr. Rasminsky, and I understand that description of the mechanism. When I asked, how does it work, I was coming back to the lag there. How fast does it work, in the sense that you influence first cash reserves of the banks, and then you get a secondary effect from that; you get a change in interest rates, long rates, short rates and so on. It is that form of mechanism I would like you to comment on. How does one step influence the other? Where does it end up? How long does it take, roughly - do you think you can be precise on it?

MR. RASMINSKY: On the last question, Mr. Leman, I have to say immediately that I don't know. I can't give any precise answer as to how

long it takes a given change in monetary policy, or a given change in credit conditions, to work its way through the economic system and result in a change in demand for goods and services. I think this must vary a good deal from time to time, depending on what else is happening in the economy and what the general expectations are regarding business prospects, and depending also on what is happening abroad. I think it must vary, too, with the intensity of the change. A very sharp change in credit conditions may well bring a much more rapid reaction through its shock effect, perhaps effecting expectations, than a more gradual change.

On the matter of lags, I think that the lags in the impact of changed credit conditions on international capital flows may be somewhat smaller than the lags on domestic spending. We have, I believe, a good many examples of the fact that relatively small changes in differential yields as between Canada and abroad can produce quite large and rapid changes in international capital flow.

COMMISSIONER LEMAN: This brings me to another reference in your submission. It is the fact that you say this must in part operate through the process which you call successive approximation. Could you illustrate this process for us in a concrete or semi-concrete situation of circumstances of your own choice? For instance, paragraph 49 of section 2 refers to this process of successive approximation.

MR. RASMINSKY: It comes back, Mr. Leman, I think, to something I said before. There are occasions when the requirements of policy change very abruptly and in which the central bank has pretty clearly formulated objectives and can go straight after those objectives. The experience of the past summer was such a case, and there was a fairly abrupt impact on monetary policy, with monetary policy directed primarily to producing enough capital inflow to restore the reserves. But even after that there was some process that I think one could reasonably describe as successive approximation. One does not know, even with so concrete an objective as that, the differential in interest rates required. As one got the experience of capital being returned to Canada, after starting in July and August, through a process of successive approximation, there was some easing of the situation, resulting in a decline both in the absolute level of interest rates and in the interest rate spreads as between Canada and the United States. However, I think that is rather an unusual case because it does not happen very frequently that the objectives are as clearly defined. In the usual case one reaches a conclusion in a general way as to the direction in which monetary policy should be moving. You watch the behavior of monetary and non-monetary factors; you try to look ahead a bit; you don't move abruptly, as in a situation where the economy is moving ahead, where it is impinging on its resources

or reaching that point. Then you would permit or encourage a gradual tightening of credit conditions through a process of testing and probing. If in that process the behaviour of your economy suggested that you shouldn't go as far in that direction, you would retrace your steps a bit, using one of the chief merits that the monetary instrument has, namely, flexibility.

COMMISSIONER MACKINTOSH: I take it what you are testing there is the response. You are not trying to determine what the condition of the economy is, but the response it will make to certain large or small moves.

MR. RASMINSKY: I think that is correct, Dr. Mackintosh. It is the condition of the economy - your appreciation of the condition of the economy - that determines your basic decision as to the direction in which you wish to move. The technique that you use, and the speed at which you move in that direction, is, as you say, in large measure a response to the action, or is conditioned by the response to the action you have already taken.

COMMISSIONER MACKINTOSH: Is the reaction that you watch more than a financial reaction? In the case that you cited of last summer, I take it that the speed and the satisfaction in the result was powerfully affected by the fact that your objective was a modification and a change in the flow of financial assets, which you got quickly. Had

it been related more to incomes and expenditures, it would have taken you longer to get to them.

My question is, are the responses that you get to your probing only financial, or do you keep it up long enough to see if you get economic responses?

MR. RASMINSKY: What we are concerned with, Dr. Mackintosh, is what is happening in the real world. We are concerned with what is happening to output, and to employment.

COMMISSIONER MACKINTOSH: "Finance" being the non-real world.

MR. RASMINSKY: Perhaps I ought to start again.

I think we would regard the financial reaction as being important in itself. The functioning of financial institutions is obviously important, but as instrumental conditions to the achievement of certain objectives. It is those objectives that I describe as the objectives of the real world.

COMMISSIONER LEMAN: The process of successive approximation in itself accounts for part of the lag we have been talking about that you said we couldn't measure exactly, but the fact that you proceed in that fashion is responsible in part for the lag.

MR. RASMINSKY: I would be better able to answer the question if I knew in what other fashion monetary policy could possibly proceed.

COMMISSIONER LEMAN: I thought we had

established at first that some of the difficulty was that you could not be sure what would happen if you did nothing at a given point; that you could not be sure of what would happen, or how far a trend would go. Then you explained to us that if you had better information on various economic indicators you could probably be more sure of how to manage this problem. Therefore, I assume that in part a successive approximation process is necessitated by the uncertainty. Presumably you would not want to overshoot the mark; therefore, you try a small dose of what you think is the right medicine, and then you decide to increase the dose if the responses are not quite what you expected. Does that pretty well describe what you call successive approximation?

MR. RASMINSKY: Yes, I think there is some parts of what you said that I think does correspond to that. Of course, one doesn't know at the beginning of this process of successive approximation, one doesn't know the precise nature of the economic situation that one is dealing with. One forms a judgment as to the direction in which the economy is moving, but if one is dealing with an upswing, the ultimate intensity, the duration of the upswing only becomes apparent as you go along and that is why it seems to me that this method which we have described as successive approximation is the only possible method by which monetary policy can be conducted. If one knew in advance the situation, what the situation was going to be six months from now, then some other method might be possible, but one doesn't know that, one has to be influenced by the development of the situation.

COMMISSIONER LEMAN: Mr. Rasminsky, there is one other point which I would like to ask you a question about, and it refers to that paragraph 17 of section II, where you say:

> "In general, the fewer the rigidities and imperfections in financial markets the more are credit conditions mainly a matter of the cost of money. The more widespread the rigidities and the imperfections the more important become considerations of availability."

Now, in the context of what we have been discussing, the effectiveness of monetary policy --

I said paragraph 17, section II?

MR. RASMINSKY: Yes, I have it.

COMMISSIONER LEMAN: In the context of what we have been discussing, namely the effectiveness and lags in the effectiveness of monetary policy, would you say it follows from the paragraph I have just read that the less imperfections in the market the more effective would be monetary policy, or is it the other way around?

MR. RASMINSKY: Well, there are occasions, Mr. Leman, when an imperfection in the market may, for a certain period of time, come to the assistance of the monetary authority. If the general view of monetary policy is that a restrictive policy is appropriate because the economy is going ahead, pressing on its resources very rapidly, then if there is a limitation on the willingness, for example, of certain lenders to lend above a certain rate of interest -- which is not unknown, because they regard it as not quite respectable -- then some borrowers may find that they are not able to get the money from their usual sources and give up their spending plans as a result. So, it is conceivable that there can be situations when imperfections in the market have the effect of reinforcing monetary policy.

This, however, seems to me to be a situation that monetary policy shouldn't count on, partly because it is not to be relied on and new channels will grow up and the money will be available at high rates from some source, and partly because I believe that the effectiveness of monetary policy is enhanced by good

credit markets. Consequently, while I think that we have to admit there are occasions when imperfections are helpful to monetary policy, I wouldn't put that forward as a reason for advocating imperfections in the credit market.

COMMISSIONER LEMAN: It depends on the type of imperfections we can think of, is that right? Some imperfections tend to reinforce the effectiveness of monetary policy and other types tend to weaken it.

MR. RASMINSKY: I think that is right.

COMMISSIONER MAKINTOSH: We had Professor Erik Lundberg who told us the thing to do, I think, for short-term policy was to barge in and create imperfections in the market so as to disrupt it thoroughly.

THE CHAIRMAN: We shall now adjourn until tomorrow morning at 9:15.

--- Adjournment.

Ottawa, Ontario,
Thursday,
January 10, 1963.

--- At 9.15 A.M. the hearing resumed.

THE CHAIRMAN: I will call the meeting to order.

MR. RASMINSKY: Mr. Chairman, I wonder whether I could be permitted to go back to the interesting line of questioning of Mr. Leman yesterday afternoon. Mr. Leman's questions were, I think, directed to endeavouring to ascertain what degree of precise knowledge the central bank had of the impact of changes in credit conditions in different sectors of the economy, and what it knew about the various lags that might be involved in the impact of these conditions.

The general line of my reply was that we did not have a great deal of precise quantitative knowledge regarding either of these things, that we made the best use we could of the information available, that we tried to do what we could to improve, to help in improving the information, that the information available was, we thought, sufficient to enable us to try to use our powers to move monetary policy and credit conditions in the right direction, in the direction required by the economic circumstances, even though we did not have detailed quantitative knowledge as to the points of impact or the prices involved, that we were engaged

in a process of endeavouring to narrow the range of uncertainties in these things, but that I could not honestly say to the Commission that we did in fact have detailed measureable knowledge.

In some discussion that we have had in the Bank since then I found that my colleagues, while not unduly critical, I am glad to say, of the answers I gave to this line of questioning, felt that I may have left the impression we did not feel that such detailed, precise knowledge would be of considerable value to us, or that we did not think it was worthwhile doing everything possible to quantify our knowledge of the points of impact and the lags involved.

I hope that the record will not indicate such a view on my part, for I do not hold that view. I think that it is in fact extremely important to endeavour to measure these things to the extent that we can. It would be fair to say that in the Bank we have felt that the beginning of this process was an improvement in the underlying statistical data, and our own efforts in the Bank have been largely concentrated on improving underlying statistical information as the main prerequisite to improved monetary analysis and financial analysis of a quantitative.type, and with the co-operation of the chartered banks, monetary and banking statistics have, I think, been improved in this country to the point where they compare favourably with corresponding statistics of almost any country.

Furthermore, over the years the Research Department of the Bank has also taken part in the development of a wide variety of statistical developments such as the national accounts, the balance of payments, consumer credit, information regarding the assets and liabilities of life insurance companies and finance companies, the security markets, stock market credit, government financial accounts, and other financial series.

In recent years we have co-operated with the Dominion Bureau of Statistics in planning a more comprehensive framework of financial statistics, and the Bureau is now engaged in carrying out this work.

This includes a variety of quarterly balance sheet data including the financial assets and liabilities of various sectors of the economy, and this should make it possible, we feel, for current financial analysis to be carried on more on a sector by sector basis than on an aggregative basis, which will certainly improve quantitative financial analysis.

The development of statistical series involved, and their adjustment for seasonal fluctuations, will naturally take some time, but it is an important job and a start has been made on it.

As I say, the effort of the Bank and particularly its Research Department, has been concentrated in trying to improve the underlying data rather than to do econometric work on the basis of the existing data which, in many fields, are in-

adequate. We follow the quantitative work that is being done by others. We know that some work is being done along these lines by the staff of the Commission. In fact, one of the men to whom you referred yesterday, Mr. Chairman, and whom we have loaned to the Commission, participated in one such study and we look forward with a great deal of interest to this work. I can assure you that if this work does show signs of giving promising indications of producing results that are worth pursuing, it would be the intention of the Bank to pursue work of this type.

I desired to make this statement because I would not like either the impression in the minds of the Commission or the record to indicate that there was any lack of desire on my part, or even any lack of enthusiasm, for pushing ahead in the field of quantitative monetary analysis to the fullest useful extent.

COMMISSIONER BROWN: Thank you, Mr. Rasminsky. This leads on to a question which I had, and indeed your comments have answered it in part. One of these lags you refer to several times in your submission is the delay in the effective changes, which you originate in Bank reserves, being reflected in bank lending policy.

I think this is something which can only be measured by the Bank, for it is only the Bank that initiates such changes, based on other statistical information, and we recognize the lag that exists and the problems you have in getting this

other information. However, in view of the fact that you do refer to this on several occasions, can you give us any picture of the sort of lag that is involved. You see a situation which you regard as requiring something being done by the Bank. Have you any picture of how long this gets reflected, not in what we called yesterday the "real world of the goods and services", but when it starts to get reflected in bank lending policies.

MR. RASMINSKY: I do not think, Mr. Brown, there could be any single answer to that. A very important element in that lag would be: What is the existing loaned-up situation of the banking system? If the banking system was already loaned-up and if the ratio of loans and other non-liquid assets to the total liabilities or assets of the banking system was already on the side that the banks regarded in the light of historical or other standards as high, then one would expect that a tight monetary policy might be transmitted more rapidly to lending policies than a situation where the banks have plenty of liquid assets and government securities, were their liquidity is great.

Another factor in that situation, of course, is the extent to which the banks are committed to make loans at different time periods as a result of previous authorization of lines of credit. Perhaps the word "commitment" is one I should not use in that connection, but the extent to which they have given indications to their customers that lines

of credit are available.

It may be, Mr. Brown, when you question the banks that they will be able to give a more precise indication than I have regarding the time periods that are involved, but I think that that is as good an answer as I can give you.

COMMISSIONER BROWN: This has happened two or three times in the last several years. Have you noticed any tendency on the part of the banks to be a little more ready for your actions in the sense of shortening up their holdings of government bonds so they are less affected by changes in interest rates in disposing of their liquid securities?

MR. RASMINSKY: I think it is the case that the average turn to maturity of the government security portfolio held by the banks has been shortened, which would mean that the losses involved as a result of having to liquidate securities have been less.

This is a consideration that, of course, runs counter to the normal consideration of the banks to want to maximize their earnings. Normally the yields of long-term securities are higher, as you know, than those of short-term securities.

COMMISSIONER BROWN: What I am getting at, of course, is this. Does this thereby tend to tie your hands a little bit and make it necessary for you to look towards other means of shortening this lag, of getting a faster reaction? In other words, are the banks trying to protect themselves against

what you might do to get them to do what you want them to do.

MR. RASMINSKY: I do not believe, Mr. Brown, that it is the shortening of government securities which reduces the impact so much of the central bank in respect of loan policies as it is the fact that the banks' total liquid assets, including government securities, may from time to time be so high that a tightening of credit conditions or an attempt on the part of the central bank to tighten credit conditions takes place in a period where the banks are able to sell large amounts of securities.

In that connection what would be involved would be the total amount of liquid assets that the banks felt that they were able to dispose of in order to finance an increased loan demand.

COMMISSIONER BROWN: Yes, you refer to that in a couple of places in your submission.

MR. RASMINSKY: Yes. Of course, anything that the banks themselves can do to increase the responsiveness of their lending policies to monetary action on the part of the central bank would, I think, be helpful to the central bank, would be helpful in producing appropriate credit conditions.

COMMISSIONER BROWN: In another context you also mention in several places, and I think it was mentioned yesterday, that international capital flows are particularly sensitive and in, I think it is, paragraph 25 of section 3, you make the point that Canada is probably more sensitive than almost any

other country to changes in long-term rates.

I was wondering if you could tell us why this was so? Have you got a theory as to why this should be so applicable to Canada?

MR. RASMINSKY: I suppose, Mr. Brown, it is on account of our close financial relationship with the United States, the fact that so many Canadian borrowers have access to the American market and are consequently able to regard borrowing in United States as an alternative to borrowing in Canada, or if one looks at it from the point of view of the American investor, the American investor has tended over the years to regard Canadian securities in a rather different light from other foreign securities and has been more disposed to put money up here if encouraged to do so by attractive yields.

COMMISSIONER BROWN: You mentioned yesterday that a considerable part of the capital inflow, particularly in recent years, has come about, irrespective of interest rate differentials, through direct capital investment. Does this of itself produce problems from the point of view of the central bank in that it might require larger off-setting action in interest rate differentials?

MR. RASMINSKY: In the situation we are in, Mr. Brown, I should have thought that that factor would tend to work rather in the opposite direction. Our position for some time has been that we have had a large current deficit in our balance of payments which requires to be financed

through the inflow of capital to the extent that these capital inflows take forms that are independent of interest rate considerations, then the job remaining to be done by the interest rate differential in producing the requisite capital inflow is, if anything, reduced.

COMMISSIONER BROWN: I was thinking more from the point of view, if you wanted to dissuade or slow down capital inflow at some stage. This is probably a theoretical discussion at the moment, so perhaps it is not worth persuing.

In paragraph 65 of section II you mention the relative problems of small businesses and large businesses in borrowing, and refer to the special concern that chartered banks feel in making adequate credit facilities available to small borrowers. Do you feel that the concern taken by the chartered banks is doing the job, looked at from an outsider's point of view?

MR. RASMINSKY: Well, I do not suppose that that job will ever be done to the satisfaction of all concerned. There remains a variety of small business demands, as of other credit demands, which are not satisfied through the banking system; and various institutions -- including the Industrial Development Bank, which you will be examining later on -- have been established to try to meet that residual demand. I think it is the case that over the years the growth of small loans in the banking system has been quite striking. Sometime ago we asked the banks to supply us with information, which we publish regarding their loans outstanding in various size categories.

When one takes the period, say, from September, 1956 to September, 1962, general loans, which include business loans and personal loans, increased by 2.6 billion dollars, or 63 per cent. Small loans increased by 71 per cent, or 1.5 billion dollars, and large loans

by 1.1 billion dollars, or 54 per cent. Incidentally, loans in this classification, small loans, are loans under authorized limits below $100,00C, and large loans are loans under authorized limits above $100,000. These figures that I have given refer to business loans. I am sorry, the figures I have given refer to total general loans, including personal as well as business loans.

I would not like to suggest, Mr. Brown, that there is no remaining gap in the financial system, as regards the provision of finance to small borrowers, but the banks have stated that they make a special effort to look after the requirements of their small customers, and I believe it is the case that they have done so.

COMMISSIONER BROWN: Does this mean that the pendulum has swung a little too far, perhaps, in favour of the small business loans? Is there a discriminatory effect here, somewhere, in the impact of monetary policy?

MR. RASMINSKY: No, I do not think that is the case. I do not think that there is any discrimination in favour of small loans. I think that an important part of the dynamic of the banking system is the desire to attract, on the part of the banks, and retain large customers, and that involves large loans. Large borrowers, of course, have access to other sources of credit in some cases. They can have recourse to the capital market, where that would be either impossible or costly to small borrowers. But I would not want what I have said regarding the acceptance of some degree of responsibility on the part of the banking system to

look after the requirements of their smaller customers to indicate that there has been discrimination against the large borrowers.

COMMISSIONER BROWN: In other words, you feel that things are balanced out on total, so that there is more or less an even impact of monetary policies on businesses throughout the country?

MR. RASMINSKY: The fact that the large borrower has alternative sources of borrowing, where in many cases the small borrower does not have alternative sources of borrowing, does in itself, I think, tend to put the small borrower at some disadvantage in obtaining his funds in a period of monetary restraint.

COMMISSIONER BROWN: Following up that, in paragraph 66, you say:

> "If central bank operations are to have a relatively uniform effect throughout the economy, there must be a sufficient diversity of financial institutions which specialize in meeting the needs of particular categories of borrowers."

I wonder if you could comment on that. It is not quite clear to me whether this is an equivocal statement in the sense that there is not now a sufficient diversity of financial institutions.

MR. RASMINSKY: I do not think I can comment on it in great detail, Mr. Brown. I have referred to the fact that there have recently been some developments of specialized institutions looking to the needs of small borrowers. Perhaps more could be done in that direction. It may be that an example of what we have in mind in

paragraph 66 would be the provision of mortgage money. The fact that the government itself is so directly involved in providing mortgage money, I think, is prima facie evidence that there is a lack of specialized institutions for that purpose. I think that this is particularly true as regards the provision of mortgages in places outside the main centres.

COMMISSIONER BROWN: What other types of financial institutions do you have in mind in this paragraph?

MR. RASMINSKY: One illustration is one I have suggested, institutions that would provide mortgage money. I am thinking now particularly of house mortgages in places outside of the main centres, which are better looked after.

COMMISSIONER BROWN: Do I gather from this that you are satisfied that even though these institutions were not directly subject to central bank requirements at all, the indirect effects through the banking system would result in, as you say, central bank operations having a relatively uniform effect throughout the economy?

MR. RASMINSKY: May I ask where that is stated?

COMMISSIONER BROWN: That is paragraph 66 still.

MR. RASMINSKY: I am sorry, Mr. Brown, but I do not quite understand the question. There are rigidities in the financial system and borrowers cannot turn, without difficulty, from one institution to

another. There are rigidities affecting loans. I do not think that the establishment of a new type of institution, of a type that may be envisaged under paragraph 66, would change that situation. I am afraid I have not quite understood the point of your question, Mr. Brown.

COMMISSIONER BROWN: Well, my point is this. You say that:

> "If central bank operations are to have a relatively uniform effect throughout the economy, there must be a sufficient diversity of financial institutions which specialize in meeting the needs of particular categories of borrowers."

As I understand it, what you have said now is that there are rigidities, and if these other financial institutions were developed these rigidities would still exist.

MR. RASMINSKY: As we go on to say in the next paragraph, Mr. Brown, this depends not only on the existence of institutions, but on the practices of institutions -- on the degree of flexibility, for example, in their interest rates. So, the establishment of a variety of institutions would not automatically produce evenness in the impact of monetary policy, though it would help. If there are institutions established which specialize in the provision of credit requirements of a certain type and do this year in, and year out, rather than provide credit requirements of that type only in circumstances in which they are

relatively flush with funds, and turn the tap off for that particular type of credit if the situation tightens, then that situation constitutes an element of -- well, if there is a variety of institutions, then the impact of monetary policy is more likely to be even.

COMMISSIONER BROWN: This is my question then, you are satisfied this would take place even though these institutions did not come under the direct impact of central bank operations?

MR. RASMINSKY: Mr. Brown, the point I was trying to make yesterday, which I think you may be referring to, is that in our judgment the fact that a certain group of financial intermediaries, called the near-banks, do not come under the fractional reserve system and are not required, or agree to maintain certain liquid asset ratios, does not, in our judgment, constitute a major impediment to the exercise of monetary policy.

COMMISSIONER BROWN: That is what I wanted to get on the record, in this particular context.

MR. RASMINSKY: Yes. However, that does not mean that monetary policy, or the impact of monetary policy, or changed credit conditions, is necessarily even. It would not be even, I think, if you have regidities in interest rates and other imperfections in the market. It would not be even whether or not these institutions were members of the fractional reserve system.

COMMISSIONER BROWN: Not insofar as those institutions are concerned that have these rigidities.

I was going to discuss that point next.

MR. RASMINSKY: The only point I was trying to establish yesterday was that the impact of a policy of monetary restraint on the financial system is widely dispersed through the financial system, even though not all members of the financial system are subject to any central bank control. I was not trying to establish the point that the impact is necessarily uniform throughout the financial system.

COMMISSIONER BROWN: I think we recognize that; and that is, uniform not only in impact but in the speed of impact that is not uniform.

MR. RASMINSKY: That may be the case too.

COMMISSIONER BROWN: There may be areas that not only do not suffer from the same impact, but also those which do, and there is still a difference in lag because of the mechanics of the operation through the system.

MR. RASMINSKY: Yes. Although there one would think that the impact would be fairly speedy. After all, all these institutions -- banks and near-banks alike -- are, as we look at it, competing for the deposits or the financial assets of the public; and one would expect that that being the case the transfusion or transmission of the results would be fairly speedy.

COMMISSIONER BROWN: This is one of the measures on which we agreed earlier, but we have not got the facts as yet.

MR. RASMINSKY: Yes, that is right.

COMMISSIONER BROWN: In the next paragraph, to which you have already referred, you talk about legal restrictions and institutional practices. I assume that you are referring to such things as the 6 per cent ceiling on bank interest rates, and things like NHA loans?

MR. RASMINSKY: Those are among the institutional practices, yes.

COMMISSIONER BROWN: This results in an unevenness, but it does not slow down the effect of monetary policy; in fact, it possibly increases it, does it not?

MR. RASMINSKY: If one thinks of the 6 per cent bank rate it means that monetary policy does not operate through a market mechanism. That is, if you do not get rationing , any degree of rationing through price, once the ceiling is reached. You get direct rationing. What happens after that depends upon what possibilities the frustrated borrower who is rationed out has of raising the funds elsewhere, and the price that he has to pay for doing so.

COMMISSIONER BROWN: In another paragraph a little further on, paragraph 70, you say -- and this is referring to the impact of monetary policy on financial markets -- you say:

> "There must, however, be some limit to the degree of price fluctuation which financial markets can be expected to sustain ..."

Would you like to elaborate on this, and can you give us any examples?

MR. RASMINSKY: Well, I can't give you any historical examples, at least from our history, because I think the degree of price fluctuation that has been experienced in the prices of bonds has been of a magnitude within the capacity of financial institutions to absorb. I would not want to make too much of this point, but many financial institutions carry their securities on the basis of amortized cost, and this reduces the impact of this.

Wide price fluctuations could, of course, reduce the willingness of investment dealers to hold inventories when prices fall and constitute an additional element of instability in the market, but I do not think that historically the impact on financial institutions has in this country been a limitation on the use of monetary policy.

COMMISSIONER BROWN: You make a somewhat similar reference two paragraphs further on when you say:

"..it is only realistic to recognize that credit conditions can become too extreme to be accepted by the public . . . "

MR. RASMINSKY: Yes.

COMMISSIONER BROWN: What does the public do?

MR. RASMINSKY: Well, it is not the public, I suppose, that does anything; it is those who can influence credit conditions. This is put forward as one of the limitations on the use of the monetary instruments; that the thing can be carried to the point -- the extremes could be carried to a point where the fluctuations are so great as to be unacceptable to public opinion.

Now, I couldn't again be precise as to what that point is. I think that it may be that here you are in the area of conventional notions, that change from time to time as to what is a tolerable rate of interest. It may be that you get used for a time to one rate of interest as looking as though it is the upper limit, and that is acceptable and ---

COMMISSIONER BROWN: In other words, what is the low interest rate and what is the high interest rate?

MR. RASMINSKY: That is right; your ideas as to what is the acceptable, tolerable high or low interest rate change from time to time. Of course, what is acceptable -- I don't know whether it is dealt with in this paragraph -- but what is

acceptable in the field of interest rate fluctuations in Canada must also be affected by the range of fluctuations in other countries, particularly in the United States on account of the closeness of our contact with them and the importance of capital flows.

COMMISSIONER BROWN: Do you think that this level has been changing? You refer elsewhere to the fact that the rate of interest doesn't seem to be taken into consideration by consumers on consumer borrowing. Are we all getting more accustomed to higher rates of interest?

MR. RASMINSKY: I don't know whether we are getting accustomed to them, but it is the case that in Canada, as in many other countries, the rates of interest that were regarded as normal or acceptable during the early post-war period were considerably lower during the period of great liquidity in the economy, produced in part by the war; that these rates were considerably lower than the rates of interest that have prevailed in recent years.

COMMISSIONER BROWN: Again talking in the same sort of context, you refer in paragraph 74 to the possibility of perverse reactions in the markets. Is this a serious problem, or do you merely regard it as something which you have to watch carefully? Are you thinking of the post-war developments in England where they tried to force interest rates down too far and it got to a point ---

MR. RASMINSKY: I wouldn't want to refer to any specific examples from other countries.

COMMISSIONER BROWN: I made the reference!

MR. RASMINSKY: Yes, I don't think that this problem has arisen in Canada, but I think that there is enough experience in some other countries to warn the public authorities that they should not push things too far too rapidly and expect that investors will at all times be willing to go along with what their views are as to the appropriate rate of interest.

COMMISSIONER BROWN: And does this work in both directions, in your opinion; does this place limits on it in both directions?

MR. RASMINSKY: Yes, it does.

COMMISSIONER BROWN: In other words, you can push interest rates so high that people get frightened and will not go in at almost any rate.

MR. RASMINSKY: I think there is that limitation on the up-side, too, yes.

COMMISSIONER BROWN: In our travels across Canada we have had several representations about the regional differences and that there are variations in credit conditions across Canada. Have you any comment about any rigidities in our market that contribute towards this?

It seems to me that with our banking system funds move very readily to any point in Canada. Could there be rigidities that contribute towards these

different credit rates, different interest rates, for relatively the same credits?

MR. RASMINSKY: I don't think so, Mr. Brown; to my knowledge this is not the result of any rigidities in the system. I don't think it could be argued that the existence of national institutions or a branch banking system throughout the country acts as a discrimination against the outlying parts of the country. If anything, I would expect that a national system provides the outlying parts of the country with better access to credits than would be the case if they relied entirely on their own resources.

COMMISSIONER BROWN: This, I think, is generally accepted, but we do have differences in interest rates in municipal securities and in mortgage funds. Would you care to comment on this at all?

MR. RASMINSKY: I don't think I could make a useful comment on it. There are all sorts of differences in interest rates within any particular region as well as between regions, and presumably these rates reflect the appraisal of investors as to the credit which is involved.

COMMISSIONER LEMAN: May I interject a question, Mr. Brown?

COMMISSIONER BROWN: Certainly.

COMMISSIONER LEMAN: The way this came up in other cases was that some regional situations took this form; people would argue that

even if in, say, the central provinces the economy was under pressure in those areas, their regional economies were not under pressure, and would there be any possibility of isolating them from any restrictive action. That is the way it came up.

MR. RASMINSKY: Yes.

COMMISSIONER LEMAN: Do you feel that this is an impractical concept?

MR. RASMINSKY: I think with a national currency, with a national monetary system, Mr. Leman, that you cannot have regional monetary policies; that all you can have is a general monetary policy, and I believe that the same conclusion was reached by Professor Cairncross who made a specific study of this subject a year or two ago. On some particular rates, national rates, of course, there is a complete absence of discrimination. The N.H.A. mortgage rate, for example, is uniform across the country.

COMMISSIONER MACKINTOSH: I would like to ask one or two questions, Mr. Rasminsky, to clarify what you had to say about some of the tools and techniques that the bank has to carry out its policies.

You indicated that there was a range of cash ratios authorized by statute, and my recollection is that you argued that except under unusual circumstances that the variation of the cash ratio by the central bank was a fairly rough type of instrument which might have to be used but wasn't for frequent use.

You also indicated, I think, that there was some desire for a revision of the formula by which the cash ratio was calculated. Would you be good enough to explain the present formula and the type of modification to it that you think desirable. I think it is at page 38 in the appendix to that section.

MR. RASMINSKY: Yes; I was trying to see whether in the submission itself we gave a description of the present formula, to begin with.

The present formula requires that the banks maintain 8 per cent of their deposit liabilities in the form of balances with the Bank of Canada, or in Bank of Canada notes. The deposit liabilities are their current deposit liabilities. Their deposit liabilities all relate to the past period. The deposit liabilities are the average of their deposits and the close of business on the Wednesday in each of these four consecutive weeks ending with the last Wednesday but one in the preceding month. That gives a past base for the deposit liability.

There is similarly a historical calculation for the same period of their till money, the actual notes that the banks hold in their tills.

So, the banks know at the beginning of each calendar month how much they need in the form of deposits with the Bank of Canada in order to make up the required 8 per cent. That is what the present formula is.

The Bank has the power, which it has never exercised, to vary that 8 per cent within the range of

8 to 12 per cent at certain intervals by giving a month's notice, and varying, I believe, by not more than one percentage point each month.

The cash reserve requirement is the basic mechanism through which the Bank exercises a control over the total of the deposit liabilities of the banking system. This control, however, is not as precise as is sometimes thought. Sometimes in reading the papers, for example, one would get the impression in a particular week that the Bank of Canada had decided it was a good idea to increase the money supply by $170 million and has given the banks the necessary cash to do so in that week. That is not the way the system works in practice. The Bank does not have, nor, indeed, does it need, that degree of precision in the control of shorter period fluctuations in the total size of the banking system.

There are various elements that enter into the lack of precise control. There are various slippages in the system. One of these slippages is the one that we have referred to earlier this morning, namely, that the amount of loans on the books of the banks at any particular time is not responsive to the amount of cash that they have at that particular moment of time. They are the result of authorizations that the banks have made in the past which are drawn down on the initiative of the borrowers, and they are not immediately responsive to cash management.

Another reason for the lack of precision in central bank control is that the banks do not

all work to the same ratio. They all, of course, have to achieve the ratio of 8 per cent in the course of any given month, but within a certain limit the banks have different ideas as to the cash ratio target at which they are aiming.

More important, perhaps, than that is the fact that the banks do not work consistently to the same cash ratio. Even if they did not work to different cash ratios but worked consistently to a given ratio, then allowing for changes that would take place over a long period of time as a result of changes in the relative sizes of the different banks the central bank would know, insofar as it lay within the power of the banking system, that a given degree of central bank cash would produce certain quantitative effects.

The banks are required to maintain this 8 per cent ratio not daily but on an average over a period of a calendar month. This averaging period enables the banks to run relatively low ratios in one part of the month, planning to recoup or to run higher ratios at a different time of the month and still maintain the average. This means, of course, that the banks have a considerable element of choice as to how to respond at any particular moment of time to a given cash situation. So, the central bank never knows at any given moment of time what the precise response of the banking system will be to a given injection or a given withdrawal of cash, although, over the longer period of time, since the banks have to make the 8 per cent ratio, the Bank knows that, broadly speaking,

the banks will respond by the normal multiplier of 12½ per cent. The central bank has long-run control, in other words, but it does not have immediate shorter run control.

This looseness in the response of the banking system to cash is not a terribly serious matter from the point of view of the central bank, and if the banks did not have some elasticity in their response you could get into quite a serious situation as unexpected needs for credit arose of which the central bank was not aware and for which it had not provided the cash, or as the public withdrew cash from the banking system in the form of till money thus affecting the banks' deposits with the Bank of Canada. However, too much variability does impair the effectiveness of the cash reserve ratio as a control mechanism.

The way the banks respond is less certain, less predictable and slower than would otherwise be the case, and consequently, the cash swings themselves, if one is setting out to produce certain credit conditions, would have to be greater.

The response of the banks is also effected by the distribution of cash money. If the surplus cash in the system tends to be concentrated in a large bank, for example, the system as a whole may be tighter than the central bank wants it to be.

For these reasons it seems to us that it would be desirable for the banks to work to a consistent daily cash ratio. Some of them, in this respect, perform differently from others. The daily ratio of some banks

moves within a wider arc or a wider range than the daily ratio of other banks.

We do not have any firm, fixed ideas about this, but it is our tentative view that the month-long averaging period provides not enough incentive to the banking system to work to consistent cash ratios. It provides too much time in which to recoup the short fall from the 8 per cent if the bank has that at the beginning of the month, or to make use later in the month of some surplus cash accumulated earlier in the month. We would not want to impose a rigid system, but we think there is some merit in considering a somewhat shorter averaging period than the present one of a calendar month.

COMMISSIONER MACKINTOSH: Would two weeks be somewhat shorter than a month?

MR. RASMINSKY: Two weeks would be half as long! Yes, two weeks would, we think, provide considerably more incentive to the banks to work to a consistent daily ratio. Of course, the banks, in any case, even if they work to a consistent daily ratio, will not be able to attain it because they are not in complete control of this situation at all, for some of the reasons that I have mentioned, but they would come closer to it under a two-week averaging period than a month-long averaging period.

COMMISSIONER MACKINTOSH: But it would still be a two-week historical period?

MR. RASMINSKY: I think that there is merit, Dr. Mackintosh, in certainty, and the system of basing

the cash requirements on the figures that have already been established is one that we would not suggest the changing.

COMMISSIONER MACKINTOSH: To what extent has this problem arisen because the prescribed cash ratio is higher than the banks would probably keep if they were merely safeguarding their own liquidity needs.

MR. RASMINSKY: I am not aware that it is higher, Dr. Mackintosh. I do not know that the banks have expressed views on that as a group. I believe that the President of one of the banks has indicated that the 8 per cent ratio is one that that bank, at any rate, would regard as the right ratio.

COMMISSIONER MACKINTOSH: I would infer, if they behaved somewhat differently on the later Wednesdays of the month than they do on the earlier Wednesdays of the month, that they think there is unnecessary cash -- unnecessary from the point of view of the flows of their business.

MR. RASMINSKY: In some cases they do the opposite. They will have higher ratios in the early part of the month and lower ones at the later part of the month. I think the important thing is that the required cash ratios should not be of a character that would encourage the banks to hold surplus cash at all times because it is the ability to use the surplus over the ratio that is one of the factors that produces the unpredictability in the system.

COMMISSIONER MACKINTOSH: I take it that what you depend on there is the inate disposition to hold

earning rather than non-earning assets?

MR. RASMINSKY: That is quite right.

COMMISSIONER MACKINTOSH: This is one of the factors that you can depend upon.

MR. RASMINSKY: Yes.

COMMISSIONER MACKINTOSH: To what extent is the operation of this system affected by the fact that we have very few banks, some of them being very large? You indicated one instance where one of the very large banks had surplus cash and when the others might be a bit short.

MR. RASMINSKY: Yes, we did refer to this in our submission. The fact that there are few banks does create the possibility that if they act in unison they could add to their assets without any encouragement from the cash side, and without fear of cash drain or too much cash drain. In a unit banking system with a large number of banks no single bank -- any single bank that takes the initiative in adding substantial amounts to its assets -- is likely through the clearings to be faced with a loss of funds. In our system where a few banks constitute the greater bulk of the banking system the chances that the banking system as a whole will, for example, at the time of a new issue of securities, take the initiative in adding considerable amounts to their portfolios, or be faced with a surge of loan demand -- the chances of that happening are greater than they would be if the system were not as highly concentrated as it is.

This means, of course, to the extent that that happens, that the central bank is confronted later

with the alternative of providing the cash necessary to support the increased level of bank deposits resulting from this action, or, alternatively, of not providing the cash to support it and, therefore, creating a situation in which the banking system as a whole has to dispose of assets.

COMMISSIONER MACKINTOSH: I wonder if you could clear my mind a little on what the difficulty or undesirable features of the latter course of action would be?

MR. RASMINSKY: The undesirable part of it, Dr. Mackintosh, is the risk that it would create instability in security markets. In the latter case, if the central bank feels that the expansion in the monetary system has gone beyond the point that it considers appropriate and it forces the banks to give up the securities they have acquired, or something else for that reason, then non-bank buyers have to be found for these securities, and that may affect the level of security prices. Of course, the central bank would have the alternative at the time, if it knew that this were happening and if it did not like it, of selling securities into the market itself.

COMMISSIONER MACKINTOSH: Yes.

MR. RASMINSKY: In many cases that is not really a practical alternative, for this is likely to happen at the time of a new issue when the central bank may feel certain inhibitions about appearing in the market as the seller of services --

COMMISSIONER MACKINTOSH: Perhaps some conflict of interest?

MR. RASMINSKY: Or some feeling of responsibility, shall we say? Of course, we are not certain as to what is happening at the time of a new issue. We receive reports from our contacts in the market as to how the issue is going and who is buying it, but we

do not know until perhaps a week or two later, in fact, perhaps three weeks-after the delivery of the issue - when the dust has cleared away, just how much buying of this type there has been.

--- Short recess.

COMMISSIONER MACKINTOSH: I should like to pursue just a step further the points we were discussing, Mr. Rasminsky, before the recess. As the agent for the issuer, would not the Bank of Canada know pretty well through the issuing period what the banks were acquiring by way of securities?

MR. RASMINSKY: We get no direct information on that, Dr. Mackintosh. Such information as we have is obtained on a non-organized basis. The Bank is in continuous contact with the elements in the investment market, the investment dealers who handle the new issue, and of course we have contacts with the banks as well. We get an impression from them as to who is buying the securities that are offered, bank or non-bank investors.

COMMISSIONER MACKINTOSH: Do the banks buy through investment dealers?

MR. RASMINSKY: Yes. As a matter of fact, the bulk of the chartered banks' purchases of a new issue for investment account are obtained in that way, through investment dealers.

COMMISSIONER MACKINTOSH: To the degree that you have knowledge or impressions, arrangements could be made for transfer of government deposits that would counteract this, would it not?

MR. RASMINSKY: The transfer of government deposits is one of the techniques that is open to the Bank to affect the cash position of the chartered banking system but your suggestion is that if we wanted to create a discouraging cash situation, it would be open for us to do so through the transfer of government deposits instead of selling securities?

COMMISSIONER MACKINTOSH: If you wanted to anticipate the dilemma of which you spoke earlier, provided you thought it important to do so, this might be one way.

MR. RASMINSKY: That would be a technique for tightening the banking system if we wished to do so, yes; but the range of uncertainty in this matter as to where the securities are going at any particular time is considerable, and in the ordinary course of events at the time of a new government issue the central bank would not wish to create a tight bank cash situation which could fan out and affect the whole reception of the new issue.

COMMISSIONER MACKINTOSH: This is, I take it, where you have what you referred to as a conflict of responsibility?

MR. RASMINSKY: I did not refer to a conflict of responsibility.

COMMISSIONER MACKINTOSH: I referred to the conflict --

MR. RASMINSKY: And I referred to the responsibility.

COMMISSIONER MACKINTOSH: Yes, and you referred

to the responsibility.

COMMISSIONER BROWN: May I pursue this with one or two small points?

COMMISSIONER MACKINTOSH: Yes.

COMMISSIONER BROWN: Once the bond issue has been delivered, you presumably know then what the situation is?

MR. RASMINSKY: When the bond issue has been delivered we would see from the weekly reports that we obtain on bank assets and liabilities as of Wednesday night, what the changes in each bank's portfolio of government securities have been. We would not even at that stage have any specific knowledge as to how much of the new issue had been bought by the banks, and the changes in its portfolio would be affected by that but would also be affected by any other sales of securities that it made, for example, to make room for the new issue, or any other purchases of securities that had been made.

One of the elements in the figures we get as of Wednesday night is the new issue which has been delivered as of Wednesday night. I believe arrangements are made from time to time by banks as well as other investors to take delayed delivery of securities.

COMMISSIONER BROWN: And the new cash requirement does not take place until the next month?

MR. RASMINSKY: That is right.

COMMISSIONER BROWN: So there is a period in there in which you could start to make some motions indicating that you were not very happy about this?

MR. RASMINSKY: Oh, yes, the Bank is certainly not powerless. If the trend of bank assets or the trend of deposit liabilities of the banking system is one which is displeasing to the central bank, the bank is not required to wait until the following month in order to counteract that, but the point, if I may put it this way, of the shorter period, would be to reduce the necessity of action and counter-action to try to produce a smoother situation as the result of chartered bank response to the cash position, without making it necessary for the central banks from time to time vigorously to take offsetting action to deal with the situation that it does not like.

COMMISSIONER BROWN: Has the Bank ever got to the point of suggesting to banks on a new issue that they do not wish them to acquire this new issue, and, to the extent their holdings of government bonds go up, they will reduce their government deposits?

MR. RASMINSKY: No, not to my knowledge, Mr. Brown.

COMMISSIONER BROWN: Would this be a feasible way of discouraging them from participating beyond your wishes?

MR. RASMINSKY: I suppose it would be feasible. My preference in this, as in other things, is to operate as impersonally as possible through the process of cash management without specific requests, but I would not rule myself out from making specific requests if the circumstances seemed to warrant it.

COMMISSIONER BROWN: And if somebody is doing

something which you do not like specifically, it does seem to me that you might make an approach which had a specific impact. Let me put it this way, it seems to me that you might consider making an approach which had a specific impact.

MR. RASMINSKY: I would not argue against that proposition, Mr. Brown.

COMMISSIONER BROWN: That is all I wish to ask at this point.

COMMISSIONER MACKINTOSH: I should like to ask some further questions concerning the liquid asset ratio established by agreement. Just as I inferred that some of the banks at least, to qualify it properly, hold more cash than they would feel necessary for the carrying on of their business, I presume the liquid asset ratio requires again at least some of the banks to carry more of the assets defined within that ratio than they would at all times ordinarily wish to carry; in other words, it is forcing them to carry not only more liquid but, somewhat, assets with lesser earning capacity than they might wish to carry, and it is the pressure against that which gives a measure of control.

I think you have suggested somewhere that you saw possibilities of useful action by varying that liquid asset ratio.

MR. RASMINSKY: I do not think, Dr. Mackintosh, a necessary effect of the liquid asset ratio is to force the banks to carry more liquid assets than they would at all times.

COMMISSIONER MACKINTOSH: I did not say 'at

all times."

MR. RASMINSKY: I am sorry.

COMMISSIONER MACKINTOSH: That there are sufficient occasions; I mean, if they want to carry more than 15 per cent, your rule is not any good.

MR. RASMINSKY: Then it is not effective.

COMMISSIONER MACKINTOSH: It is not effective.

MR. RASMINSKY: It does not influence their behaviour.

COMMISSIONER MACKINTOSH: So, I presume that your rule must frequently bring them up a little?

MR. RASMINSKY: What the liquid asset ratio basically is intended to do is to introduce a greater element of both gradualness and predictability in the response of the chartered banks to a tightening monetary situation as regards their loan policy.

As I indicated before, the experience seems to be that the response of the banks in their lending policies to a tightening situation is slow, and the banks are much more inclined to use up their liquid assets. They are more inclined to do that than they are to change their lending policies. I think it tends to be only when their holdings of government securities and liquid assets are quite low that they feel impelled to institute major changes in lending policies.

The banks have difficulties, which I appreciate, in making major changes in lending policies, difficulties that arise in part from the very limited number of head offices and the large number of branches,

and the difficulties of communication.

A moment ago when I referred to banks making major changes in lending policies, I meant to say "making gradual changes in lending policies". It is easier for them to make major changes by communicating different instructions to their branches than it is to make gradual changes to alter their standards of credit-worthiness, for example.

The fact that banks tend to operate this way, by selling government securities and disposing of liquid assets, is not, in my judgment, a major obstacle to the operation of monetary policy, because as they sell government securities and dispose of liquid assets in a time of strong loan demand and in a situation where the central bank is keeping the lid on things and is not providing them with additional resources to meet the loan demand, their sales of government securities naturally have an impact on the prices of government securities. They tend to push down the prices of government securities and to push up yields. In other words, they tend to tighten credit conditions, to make credit conditions more restrictive, which from the point of view of the central bank, in the situation that we are discussing, is the object of the exercise. So that I do not regard this reaction, this slow responsiveness of banks' lending policies as a major impediment in the execution of monetary policy. I think that the fixed liquid asset ratio -- which, I would presume, is not very substantially at any rate above what the banks would in any case wish to maintain -- is capable of performing a useful service, a useful function, by creating a situation where the banks would be more inclined to make somewhat more gradual changes in their lending policies and avoid the necessity of a severe change later.

On the variability of the liquid asset

ratio, I would regard this as a weapon which should be distinctly regarded as supplementary to, and by no means a substitute for, the normal techniques used by the central bank to affect the cash position.

Secondly, I would regard this as a device to be used only in exceptional, in very exceptional circumstances. The nature of the exceptional circumstances would be, I think, this, that you had a situation where the central bank felt that it was necessary to bring a more immediate impact to bear on the banks' lending policies than could be done through the ordinary processes of cash management. That would be a situation where two circumstances would have to be present: one, that there was a strong inflationary impetus in the economy, resulting in a very strong demand for bank loans; and, two, where the banking system was extremely liquid and where, therefore, a long period of time would, if one relied on the ordinary process of cash management, have to elapse before there was any effect on the banks' lending policies. This situation could arise, for example, if there was a sudden influx of foreign exchange -- I am thinking back to the 1950 situation -- or if, for one reason or another, government requirements for other purposes turned out to be very large and the central bank had to facilitate their financing. In a situation of this sort, then, it seems to me to be worth considering whether it would not be desirable for the central bank here to have power similar to

the power that the central bank in many other countries has, of impounding some of this excess liquidity and temporarily taking it away from the banking system. In a sense we already have that power, in the power to vary the cash reserve ratio, but there are certain limitations on the use of that power. That is a very strong power because it means, in effect, that you require the banking system to make an interest-free deposit with you; and it is worth considering, we think, whether it would not be worthwhile giving the central bank the power to impound liquidity without this type of consideration in mind.

I would like to repeat that such a power, if given, should be regarded as a most exceptional power, or one to be used only in the most exceptional circumstances, and to be used very sparingly. Of course, such a power would discriminate against the banks as compared to other institutions. The usefulness of the power, whether it is worth having or not, essentially depends on the imperfections of the market, because if it does have an effect on influencing bank loans, by taking resources away from the banks you will not have accomplished a great deal if the person turned away from the bank turns up somewhere else and gets his money. There are problems of equity involved in that too. So I would think of this power as an exceptional one, to be used only in extra-ordinary circumstances and to be used only for

limited periods of time.

COMMISSIONER MACKINTOSH: I take it, essentially, an action of this type would permit the banks to avoid, or require them to avoid, going through the market steps that would have to be gone through if you operate directly through the cash ratio. That is to say, I assume that they would liquidate securities and your control would become effective at the point where the probable losses inhibited them from liquidating further. Is not that roughly right?

MR. RASMINSKY: I think the essential difference between this power and the power that we now have is that if we exercised the power that we now have to vary the cash reserve requirements, then the banks would have to get the additional cash they needed by selling the liquid assets to us; and a variable ratio enables them to retain ownership of the liquid assets, but sterilizes or immobilizes them.

COMMISSIONER MACKINTOSH: There is also this difference -- and I am not sure it is an important difference, but to the degree that they did liquidate in response to your action, they would have to take their securities off a higher yield shelf to do so, if you have impounded the more liquid assets.

MR. RASMINSKY: That is right. By immobilizing the shorter term securities it would mean that to the extent the banks continued to

liquidate securities in the market there would be more pain involved.

COMMISSIONER MACKINTOSH: There is another thing that interests me, which I am not sure I can state very well. Chartered banks have limited privileges of borrowing from the Bank of Canada -- initially at bank rate and, I understand, at penalty rate later on. My impression is that the quotas for their first loans, so to speak, are pretty small in terms of the size of the institutions, and the general attitude is pretty discouraging towards this sort of borrowing. Would not there be an element of greater smoothness if they were permitted to borrow somewhat more and for a somewhat longer period than a week -- that is, shall we say, a period that would permit them to set in motion the kind of restrictions you wanted, and then go on to a discouraging penalty rate such as was thought to be desirable? In other words, if the banks, subject to pressures from the central bank, were enabled to get some temporary relief through borrowing from the central bank in larger and somewhat longer terms than at present, and then the central bank squeezed them out of that position by later penalty rates, would not this take the edge off some of the abruptness or disorganization which may follow drastic operation on their cash ratio? I am afraid I am asking you to clear up something in my own mind rather than to comment on it.

MR. RASMINSKY: It is an interesting line of inquiry, Dr. Mackintosh. The banking systems of different countries operate on the basis of different traditions with regard to central bank borrowing. Here the tradition has never been that borrowing from the central bank should be regarded as a normal source of cash to the banking system. Our normal way of providing cash to the banking system is through open market operations. However, individual banks may be faced with quite unexpected drains on their cash reserves which require access to ready cash, and the central bank has established for each bank a line of credit. In the aggregate those lines of credit amount to a sizable figure. The line of credit for each bank is a measure of its automatic access to bank credit at the bank rate. It is not a measure of its total access to central bank credit. The banks use their lines of credit with us relatively infrequently. The basic idea, or one of the basic ideas of establishing a quota, a line of credit for each bank, is to enable our agents in Toronto and Montreal to deal with applications for credit without need to refer to head office. There have been some cases where larger amounts have been requested. I know of no case where an amount in excess of the line of credit established for any particular bank has been requested and has been refused by the central bank. So that the line of credit should not be regarded as a ceiling on the access of the commercial banks.

COMMISSIONER MACKINTOSH: Would that loan in excess of the line of credit, it being an initial loan, be at bank rate?

MR. RASMINSKY: No, I was going to come to that, Dr. Mackintosh. I know of no case where a request for an additional credit over and above that has been refused.

The system has been in force for some years of charging a higher rate than the bank rate on a second application for credit in the course of any given month. The theory of that system is that the central bank does not regard access to central bank credit as a normal method for a bank to adjust its cash position. The central bank regards the normal method for any bank to correct its cash position as being to dispose of money market assets by selling short treasury bills or short-term government securities or calling day loans from the money market. Consequently, the use of central bank credit early in the month is, though permitted to a bank, rather surprising to the central bank.

The central bank would normally expect that early in the month, if the bank is running into a cash adverse clearings and a cash shortage, it would have used what we have regarded as the normal method of adjusting its position, and consequently this is the theory under which the second bite at the cherry is charged for at a somewhat higher price than the first bite.

Well, this leaves open another difference that exists and about which comment is made from time to time, between our treatment of central bank advances on the one hand and advances made directly to the money market on the other hand through the purchase and resale agreements that we enter into with money market dealers.

In the case of advances to the chartered banks, these are made for a minimum period of seven days, and the banks are charged interest for the full seven days. The case has not arisen to my knowledge of a bank wanting to repay after three days and still pay the seven day interest, but as the system is set up the banks would have to pay seven days' interest the moment they take an advance from the Bank of Canada.

COMMISSIONER MACKINTOSH: Another instance that would wring the heartstrings of any banker!

MR. RASMINSKY: Whereas in the case of money market dealers, the money market dealers can come in and out and are not limited to having

to pay interest for any minimum period of time, which does mean that they are in a sense in a better position; they can get central bank credit at less cost than the banks. This in turn again then reflects the view that we have, that the normal way of disposing of the surplus cash in the banking system is through the money market, and that the normal way of covering cash deficiencies for any bank is through the money market. It is for this reason that the system is given this bias that it has.

I think there is one other thing I would like to say on this question, Dr. Mackintosh. You indicated that it might be desirable for the limits of the banks to be higher than they are now, and I would not like to suggest that I would have a closed mind if a good case could be made.

COMMISSIONER MACKINTOSH: Is it proper to ask what the maximum is? I don't mean for individual banks.

MR. RASMINSKY: Dr. Mackintosh, if it were agreeable to the Chairman and to yourself I would be glad to give information regarding the aggregate credit limits of the central bank, both to the commercial banks and to the money market dealers to the Commission on a confidential basis.

COMMISSIONER MACKINTOSH: That would be quite adequate. The only point that sticks in my mind is a period when, because of the difficulties you have explained, or the deficiencies

in the cash ratio formula, if in a period of tight money the banks did get some of their cash by borrowing from the central bank, would you have some power in the information as to what the degree of cash stringency was in the system? That would be right there telling you, is that correct?

MR. RASMINSKY: Well, Dr. Mackintosh, before I comment on that, I wonder if I could go back and complete what I meant to say before?

COMMISSIONER MACKINTOSH: Surely.

MR. RASMINSKY: The aggregate limits of access to central bank credit of the chartered banks and the money market dealers amounts to quite a considerable sum. With regard to these credits the initiative in expanding central bank credit lies outside the hands of the central bank; the initiative lies with others. There is, therefore, I think an understandable reluctance on the part of the central bank to be too open-handed about expanding these limits.

It is perfectly true that as central bank credit comes into play that this in itself tends to create a tight situation because the central bank credit has to be repaid and the bank that owes the central bank the money has to get the cash somewhere from the money market dealer in order to do it, but I think it is understandable that there should be some regard on the part of the central bank to the automatic access that it provides to central bank credit.

COMMISSIONER MACKINTOSH: You can be more open-handed, but to get the hands of the chartered banks in the position where they could twist them, they would really be borrowers from you when you know pretty well what their cash stringency was.

MR. RASMINSKY: Well, there are occasions, of course, in which the cash policy followed is one that results -- and sometimes deliberately -- in central bank credit coming into play.

A central bank really doesn't have difficulty in producing whatever degree of cash stringency it wishes to do at any particular moment of time and the central bank is, broadly speaking, aware of how the banks feel about cash, whether the banks feel tight or otherwise, and whether the system is tight or otherwise, so that I wouldn't regard -- in reply to your question -- I wouldn't regard more frequent access on the part of the banking system to the central bank for credit as a valuable addition to the information available to the central bank.

COMMISSIONER MACKINTOSH: Well, that answers my question fully. I think that is all I have, Mr. Chairman. I might return to one or two things later.

COMMISSIONER LEMAN: Just one detail to complete what Dr. Mackintosh was talking about there.

Do you feel there is a relationship between the cash ratio formula, if it were tightened,

and this business of access to the central bank; if you tightened the cash ratio formula to offset this a little bit by some forms of easier access to the central bank?

MR. RASMINSKY: Of course, we have had no experience, as you know, Mr. Leman, with tightening the formula, for the central bank to require the commercial banks, the chartered banks, to increase their cash reserves with it, and then provide part of the money required to effect that increase. These would seem, on the face of it, to be factors that were working in a direction opposite to each other. It might be that if an increase in the cash requirements -- I am told that I have misunderstood your question.

COMMISSIONER MACKINTOSH: It is simply tightening up the formula.

MR. RASMINSKY: I beg your pardon. You mean, shortening the averaging period?

COMMISSIONER LEMAN: Right.

MR. RASMINSKY: I beg your pardon; I thought you were talking of the use of the power to vary the cash reserve requirements.

COMMISSIONER LEMAN: Oh no.

MR. RASMINSKY: No. I think I would say in reply to that that if it turned out in actual practice that a shortening of the reserve period required much more frequent access to central bank credit on a continuous basis, then a shortening of the period would not have been a very successful

undertaking because it would have meant that it had not, in fact, accomplished what it had set out to do, namely, to induce a more continuous action on the part of the banks to use their surplus cash to acquire money market assets and to adjust cash deficiencies by operating through the money market. It might be, of course, that as one was moving from one system to the other on a transitional basis that the shortening of the formula could produce more frequent access to central bank credit.

COMMISSIONER MACKINTOSH: Logically, disregarding practical difficulties, it would substitute for the uncertain and immediately unknown slippage, a controlled and known slippage; that is to say, the alternatives to the slippage would be access to the central bank?

MR. RASMINSKY: But the slippage would remain.

COMMISSIONER MACKINTOSH: There would be slippage, but it would be controlled and known and subject to your increasing penalty rates and you would know exactly who the people were who were slipping!

COMMISSIONER LEMAN: That was the point of my inquiry.

COMMISSIONER BROWN: May I ask a few questions in further -- have you finished, Mr. Leman?

COMMISSIONER LEMAN: Yes, on this point I have.

COMMISSIONER BROWN: I was wondering, Mr. Rasminsky, in your comments yesterday you referred to various possible changes in the method of handling this question of cash ratios and you mentioned one this morning, namely, doing it on a two-week basis as far as cash requirements are concerned. I assume this is based still on the average of the same four Wednesdays that exist at present?

MR. RASMINSKY: We haven't really worked out the details of this, Mr. Brown; we don't have any definite proposal to put before the Commission for consideration.

The thought would be that it would be based upon historical figures or past figures on deposit liabilities. I think that these past figures on deposit liabilities would be the most recent period that you could get, but not exactly the same period as you use under the present formula.

COMMISSIONER BROWN: I wonder if you would give us the benefit of your comments on one or two other possibilities that have been suggested, and let us deal with the extreme first, and that is that there be no legal requirements.

MR. RASMINSKY: No legal requirements. I would not approve of that.

COMMISSIONER BROWN: Well, let us go further and say why not?

MR. RASMINSKY: I think that I would

regard the legal requirements as a really essential element in the control of the banking system.

If there were no legal requirements the banks, of course, would maintain a certain cash ratio anyway, because most of what they maintain under the legal requirement is -- I don't know whether I should say "most", but a large part of it is necessary to meet clearing balances, so would be available anyway.

If there were no legal requirements, then the response of the banking system to the cash management of the central bank would be completely unpredictable and possibly very slow. Now, in theory the central bank can work against that if it doesn't like what the banks are doing; if it doesn't like the response it is getting to the amount of cash that it has decided to make available, then it can either put more cash in to coax the banks to do something with the money, or take cash away, but in principle the central bank prefers to minimize its own operations in the market and prefers not to be a very large seller of securities at one time and a very large buyer at another, and I think that this is the elaboration of the negative reply.

COMMISSIONER MACKINTOSH: You really would be relying on a conditioned reflec on the part of the bank that had inadequately been built up -- no legal requirement at all -- just assuming that they made a natural response.

COMMISSIONER BROWN: I suppose --

COMMISSIONER MACKINTOSH: It has worked in some countries where there was a very strong tradition of some ratio.

MR. RASMINSKY: That is right. One of the most stable cash ratios of any of them is the cash ratio maintained in the British banking system where there is no legal requirement.

COMMISSIONER MACKINTOSH: It is a kind of a conditioned reflex.

COMMISSIONR BROWN: How about another possibility that has been put forward, and that is that you ignore till money and look only at the reserve held in the central bank and presumably on a lower percentage basis, say, five or six per cent, but ignore the till money consideration.

MR. RASMINSKY: It would seem to me, Mr. Brown, that the till money is put in on an historical basis like the deposit liability, so that the Bank knows what the till money is. The till money consideration is relevant, it seems to me, in connection with this range of problems in this way, that one of the unfavourable elements of the month-long averaging period is the fact that it introduces quite large discontinuities in the bank's deposit requirements with the Bank of Canada from one month to another reflecting the changes in deposits which naturally, as one would expect, are larger over a four-week period than over a shorter period.

One of the favourable consequences, therefore, of shortening the period would be a reduction in the magnitude of the abrupt changes from one month to another.

The reason why such abrupt changes are a bad thing is on account of the uncertainties that they introduce as to whether the central bank is going to validate what has taken place in the previous month by providing the additional cash required, or whether it is going to take the additional cash away

and force the banks to adjust through disposing of money market assets; and similarly if there is a surplus of cash drawn out, whether it is going to leave a surplus of cash in the system or take it away. This introduces elements of uncertainty and instability into the system, which would be reduced if the discontinuities were less.

That is one source of discontinuity, but there are other sources, and one of those is the one you have referred to, namely, the large variations in the banks' holdings of till money that take place from time to time that affect their cash requirements. Another source of discontinuity is the very large variations in float that take place from month to month.

It seems to me that all of these things -- the till money side and the float side -- are things also worth looking at to see whether one could improve on the present arrangements in order to reduce the abruptness in the change in cash requirements from one month to another.

COMMISSIONER BROWN: Another possibility that has been suggested is with respect to the question of having two percentage ratios -- one based on current deposits and the other based on savings deposits, with the ratio relevant to savings deposits computed in relation to the basic amount of savings deposits on which interest is paid by the chartered banks. This would add complications to the computation of the reserve requirements. Are there other problems involved?

MR. RASMINSKY: I do not think that such a cash ratio system based on differential requirements against demand deposits and savings deposits is an impossible system. Clearly it is not an impossible system because the Americans have a similar system, although the time deposits, which in their case attract a lower rate of reserve requirements, are not,

as I understand it, chequing accounts as savings deposits here are. In their case I think I am right in saying that the aggregate cash reserve requirement against their total deposits, as they are presently composed, runs at about 9 per cent in actual fact of their total deposits.

I do not see any merit in going from the present system to one which introduces the complication of differential rates between demand deposits and savings accounts.

COMMISSIONER BROWN: In your discussion of liquidity reserves you did not mention whether you consider the change to a shorter period should be applicable to them as well as cash reserves. Was this in your mind?

MR. RASMINSKY: No, it was not, Mr. Brown. I do not think that the same problems of responsiveness and predictability arise in relation to secondary reserves as they do to the primary cash reserves, so I would not have in the mind suggesting that a shorter period should be applied to the liquid asset ratio.

COMMISSIONER BROWN: So that the 15 per cent would apply over the month ?

MR. RASMINSKY: Yes, that is a monthly average.

COMMISSIONER BROWN: Then, on the suggestion that you put forward the 15 per cent would apply on the monthly average, and the 8 per cent would apply in a shorter period?

MR. RASMINSKY: Yes.

COMMISSIONER BROWN: Now, all these have been with reference to Canadian deposits. Have you any comments on the question of a ratio with respect to external deposits or foreign deposits?

MR. RASMINSKY: I have no extended comments that I want to make on that subject. The foreign currency business of the banks, as you know, has increased a great deal in the last few years. The cash reserve and the liquid asset requirements that we have referred to relate exclusively to the Canadian dollar liabilities of the banks. Of course, if the foreign currency liabilities are on the books of foreign offices of the Canadian banks they may be subject to local liquidity requirements, but in many cases they are on the books of Canadian branches and in that case there are no such requirements.

Nearly all of the increase that has taken place in foreign currency liabilities in recent years has been domiciled on the books of Canadian branches, and I guess a major factor has been the keen competition between Canadian banks and other banks in the rates of interest paid on foreign currency deposits.

In the case of some foreign banks, particularly the United States banks, they have been subject to some statutory limitations on these rates, and this no doubt has been a factor accounting -- those limitations have recently been liberalized; they can be higher rates -- for the success of the Canadian banks in building up their foreign deposits.

It may, therefore, be that the need to maintain liquid assets against foreign liabilities is greater to the extent that they have had unusually favourable competitive circumstances, and their relatively favourable position may have been reduced as a result of the increased ability of the American banks to compete for these deposits.

These statistics that we have of the foreign currency assets and liabilities are not adequate to see what the liquidity position of the banks is on a realistic basis. They maintain deposits with foreign banks in some cases on a time basis where the deposit is fixed for a certain period of time and interest is earned on it. Until fairly recently the greater bulk of the banks' transactions in foreign currencies involved non-residents rather than residents of Canada, and there seemed to be little relationship between this aspect of their affairs and domestic monetary and banking conditions. But, in the last few years there has been a very large increase in the extent to which residents of Canada hold foreign currency deposits in Canadian banks, and the extent to which they borrow in terms of foreign currency at the Canadian branches of Canadian banks. This type of development gives the foreign currency business of the banks a much closer relationship to the domestic situation than has been the case at many times in the past.

Of course, Canadian foreign business is so large that it is easier as a practical matter for Canadian business to consider foreign currency financing

as an alternative to Canadian domestic currency financing than it would be in many other countries where natural exchange rate hedges were not provided as a result of business itself.

The opportunities of Canadians to engage in foreign currency banking, of course, is not restricted to Canadian banks. Canadian banks are competitive. They have to compete with foreign banks in catering to these needs.

While this business has grown quite considerably it has close connections with the Canadian domestic economy in various ways, and without having any precise view to put forward on this it does seem to me an appropriate subject for consideration as to whether the existing information regarding this business is adequate, and as to the liquidity requirements in connection with this business.

Of course, one would want to bear in mind that the Canadian banks are in competition with foreign banks, and that their foreign business is an important source of earnings to them, and in any consideration that is given to these matters one would wish to avoid, it seems to me, placing any unnecessary difficulties in the way of Canadian banks in their competition with foreign banks for this type of business.

COMMISSIONER BROWN: Do I gather from your remarks that you have not felt that this does not create any slippage in your application of monetary

policy in Canada?

MR. RASMINSKY: No, nothing that is significant. The banks are used to thinking that they have large foreign assets to flush up their Canadian dollar resources from time to time if they are feeling particularly tight, and if they feel they can make better use of their resources in Canada than abroad, and then as conditions ease they tend to restore their foreign assets. Their net foreign position fluctuates, therefore, within a certain range, but I do not regard these actions as an impediment to the execution of monetary policy.

COMMISSIONER BROWN: Does this mean that potentially they can offset some of your actions in the initial stages of a tightening up process?

MR. RASMINSKY: I would regard the net foreign position, or the foreign assets of the banks, as one of the assets they can dispose of to obtain resources for use in some other way, if they wish to do so. Basically, the total Canadian resources that they have -- the total resources that the banking system as a whole can effectively use in Canada -- is determined by the cash policy followed by the central bank.

COMMISSIONER BROWN: I would like to ask you one question which has a slightly philosophical bias, perhaps. Several times you have said you prefer to operate through the system rather than operate directly -- through the present system, I mean, of course. In paragraph 54, you say:

"The Bank of Canada has regarded it as

desirable to leave the banks with incentive to use the money market rather than lean directly on the central bank."

That rather prompts the question -- why?

MR. RASMINSKY: Well, I think that there are reasons of principle, and reasons related to practice, for this, Mr. Brown. In principle ---

COMMISSIONER BROWN: I might say that I agree with it, but ---

MR. RASMINSKY: I am sure you could give a better explanation of the reasons for it. In principle we wish to interfere with the market as little as possible. As a matter of principle, it seems to us, it is in accordance with the predominant philosophy of the country to place a minimum of restrictions in the way of the operation of the market. We think that decentralized decisions are on the whole -- when appropriately modified where necessary by incentives -- more likely to produce the objectives that the community wants than decisions we might take.

We also believe that the whole market mechanism is more likely to perform its role in distributing the flow of funds throughout the community if the markets are broadly self-reliant and not dependent upon centralized decisions.

COMMISSIONER BROWN: Presumably this is as long as you find this works effectively?

MR. RASMINSKY: Yes. That is what I meant by saying "appropriately modified". In outlining the various alternatives open to us for exercising our influence on credit conditions, you recall that we came down on the side of tending to operate at the short end of the market, but at the same time we recognize there may be circumstances where, to produce a specific result which is sought, we would overcome our philosophic prejudice, if you like, and operate in all sections of the market.

COMMISSIONER BROWN: I have one small question on a point which was being discussed with Dr. Mackintosh, and that was that on a second bite of the cherry by a chartered bank in any one month the interest rate is, do we understand, completely subject to negotiation? In other words, there is no indication ahead of time of the basis on which they would obtain further funds?

MR. RASMINSKY: I have just had to inquire about this from the Deputy Governor, for there has not been a second advance in the course of a month during the time I have been the Governor of the Bank, but I am told that the interest rate on the second bite of the cherry is not fixed but is a negotiated rate.

COMMISSIONER LEMAN: It is not a very sweet cherry?

MR. RASMINSKY: I take it from that, Mr. Leman, you consider that it is a pretty sweet rate.

COMMISSIONER BROWN: I have one more question. I wonder, Mr. Rasminsky, whether you can give us a brief outline of the considerations in admitting dealers to the money market group?

MR. RASMINSKY: The considerations involved in that, Mr. Brown, are basically the record of performance of the dealer with regard to money market securities, the extent of his participation in the treasury bill market, the size of the inventories that he normally holds, the

extent to which he makes good markets in money market securities as indicated by the spread between his bids and offers for money market securities. These are the basic considerations involved.

COMMISSIONER BROWN: Do I gather from that that you have no concept of a limit on the number of such dealers who might participate, that just anybody who is prepared to perform adequately would be given consideration for admission to this group?

MR. RASMINSKY: That is right. We have no arbitrary notions as to the proper number of money market dealers.

COMMISSIONER BROWN: These money market dealers all have a line of credit for purchase and resale agreements with the Bank. Is there a pressure on them at all to maintain a certain inventory at all times?

MR. RASMINSKY: No.

COMMISSIONER BROWN: Or is it a question that they can move in and out?

MR. RASMINSKY: No, there is no pressure from the central bank on them to maintain an inventory at all times. The money market dealers do provide the Bank, for the Bank's confidential information, with statements of their inventory of money market assets once a week, but the central bank does not attempt to influence the decisions of money market dealers as to the inventories they shall hold.

COMMISSIONER BROWN: How is their credit related, then?

MR. RASMINSKY: How is their credit related?

COMMISSIONER BROWN: How is their credit ceiling related?

MR. RASMINSKY: We set the credit ceilings some years ago, and there has been a process of adjustment in credit ceilings. In taking into consideration what the credit ceilings shall be, the Bank looks at the figures for the money market dealers, the figures indicating the scale of operations of money market dealers, including figures of their turnover, their inventories and their financing from various sources, and it attempts to have a set of credits that is reasonable and equitable in the light of all these circumstances, but since there is no pressure on the part of the Bank to try to require money market dealers to take certain lines of credit from it, there is consequently no pressure on the part of the Bank to endeavour to require them to maintain certain inventories.

COMMISSIONER BROWN: Does the Bank have a concept of the maximum line of credit in total as far as the money market dealer is concerned? Let me put it this way. If three or four more joined the group, would this serve to increase the total, or would it require a re-distribution of the total?

MR. RASMINSKY: No; the Bank does not

have in mind a fixed maximum limit to the lines of credit available to money market dealers. I would have to add to that, Mr. Brown, the same observation I made before in response to Dr. Mackintosh, that there is what I would think would be an understandable reluctance on the part of the central bank to have very large amounts of central bank credit at the disposal of the market, where the market itself can take the initiative.

COMMISSIONER BROWN: I assume it would be the same reasoning that would be against the proposal we heard from one witness that it be open to any primary distributor to come to the Bank of Canada for re-sale and re-purchase facilities?

MR. RASMINSKY: Yes; I would not be in favour of such a proposal.

COMMISSIONER LEMAN: Mr. Chairman, just before we break off for lunch and leave the subject that we were talking about a little earlier, the cash ratio formula for the banks, the staff of the Commission has done a little study of the performance of the Bank under this formula from 1954 right through to just a few months ago. Would it be true to say that their performance has improved a great deal, that the record would show quite a movement towards working close to a flat cash ratio quite close to the statutory requirement?

MR. RASMINSKY: Yes, it is my impression that over the years, if you look at the monthly averages themselves, the figures have

tended on the average to work progressively closer to the legal minimum.

What the record would show in terms of the variation, the range of variation within any given month for individual banks, I do not know. I would be very interested to know whether your study covers that point.

COMMISSIONER LEMAN: I have not got the information for individual banks, Mr. Rasminsky, but I have it for the banks as a whole, and the way the graph is expressed is the accumulative average at Wednesdays during the month. I do not know whether one should expect that outside of Wednesday there would be great, huge fluctuations, but for the average of Wednesdays it shows a very distinct flattening out, especially pronounced in the last two or three years.

MR. RASMINSKY: Yes, that would correspond with my impression, that if one looks at the monthly average figures one will find they have tended to work closer to the ratio, and in the observation I made before I laid a lot of stress on the difficulties created by inconsistency of performance within the month.

THE CHAIRMAN: We shall adjourn now to resume at 2.15. Is that convenient under the circumstances?

MR. RASMINSKY: Yes, thank you.

--- Luncheon Adjournment.

--- Upon resuming at 2.15 P.M.

THE CHAIRMAN: We shall now resume.

MR. RASMINSKY: Mr. Chairman, I have brought up some reinforcements, in the person of Mr. Humphreys, who is Assistant Chief of our Securities Department.

THE CHAIRMAN: Very well.

COMMISSIONER BROWN: Mr. Chairman, I have one question which I overlooked among my scribbled notes this morning, which follows on from a question I was asking about the use of the open market and the functioning of the price system. That was, whether the Bank of Canada had a view on the possibility of the development of a market in federal funds between the banks, or what is referred to as federal funds in the United States.

MR. RASMINSKY: We have on occasion thought of the possible implications of the development of a market in what we would call Bank of Canada funds, and the result of this thinking, up to the present, has been that we would not wish to encourage the development of a market in Bank of Canada funds. Essentially, what we are talking about here is a new mechanism by which the surplus cash reserves in the chartered banking system -- that is, the surplus cash reserves in the form of excess deposits at the Bank of Canada over and above their legal minimum requirements -- would be directly traded between banks, either directly through negotiation

or through the intermediary of a broker. The alternative is that such funds are passed around, such surplus cash reserves as there may be in the banking system are passed around from the banks which have the surplus to the banks which have the deficiency, through the medium of the money market.

It is our present opinion that the balance of advantage as between these two systems lies in the present system, whereby these funds are passed around from bank to bank through the money market. This is for two reasons. Partly because we think that the present system is helpful to the money market itself, which we would like to see grow and develop; and, secondly, and in a way this may be just as important a reason, the surplus cash that there is in the system constitutes the real point of impact between the central bank and the credit system. It is this surplus cash that leads to a response on the part of the chartered banks, in the form of the acquisition of an asset of one type or another, presumably, in the first instance, a money market asset, and which has the initial impact effect on interest rates and on credit conditions which the central bank wishes to see by providing this surplus cash. It is, therefore, important from the point of view of the central bank that the market in this surplus central bank cash should be as good and as broad a market as possible. It would be our judgment that one is more likely to get a good and broad market, and one

where the price is responsive to the quantities, responsive to central bank influence, through the money market than if the surplus cash was passed around within the banking system itself. This for two reasons. In the first place, the money market is a bigger market; there are more participants, more money market dealers than there are banks; and, secondly, there is outside competition in the money market, in the form of off-street loans to money market dealers. So for these two reasons it seems to us that there is a better chance of getting fluctuations in the price of these surplus funds which are responsive to the conditions that the central bank is trying to create if the mechanism of the money market is used rather than if they were traded off directly between banks.

I do not mean in saying that to suggest that I think this market is now perfectly responsive or that the fluctuations in day loan rates are as wide as one might on occasion expect.

For example, towards the end of a month, when there is clearly a lot of surplus cash in the system which is not going to be needed to meet the cash requirements for the balance of the month, one would expect to see this cash put out at quite flexible rates, which does not always happen. But, at all events, for the reasons I have given, I would expect that this market would be more responsive through the money market dealers than if the market were confined to the banks themselves.

COMMISSIONER BROWN: Thank you.

COMMISSIONER LEMAN: Mr. Rasminsky, we have discussed, until now, the conventional ways in which you like to see monetary policy operate, and you have expressed a preference for general and impersonal means rather than to make ways in which there would be direct intervention. I note on page 17 of the statement you made yesterday, a sentence which I will quote:

> "I would say that the Bank of Canada's existing powers in this respect are broadly speaking satisfactory for most purposes and most situations."

There seems to be the implication there that they might not be quite satisfactory for exceptional circumstances. To get back to the main submission, in Section 3, paragraph 16, you repeat about that same view, that you prefer to operate through the market. Then in the next one, paragraph 17, again you imply that there are certain circumstances in which the Bank might need other means of operating than those we have discussed up to now.

So, let us look at alternative suggestions that this Commission has heard about. One is to obviate the difficulties in extreme circumstances that might arise, for instance, from the system forcing a true rationing of credit instead of operating merely through price, the suggestion that the Bank would have stand-by powers, say,

to impose absolute loan ceilings on all financial institutions. How would that work? What would be the advantages and disadvantages of that?

MR. RASMINSKY: I suppose the first thing you would have to do would be to revise the constitution, because some financial institutions are not federally incorporated but are incorporated under provincial law. I do not pose as a constitutional lawyer, but it would be my understanding that certain difficulties of a constitutional nature would arise.

Secondly, I do not think that such a power, to impose loan ceilings, is essential for the conduct of monetary policy, and it is not a power that we would seek. The furthest that we would think it desirable to go in that direction would be to have powers along the lines that we were discussing this morning, which would give the central bank the authority from time to time, but in exceptional situations, to impound various amounts of liquidity in the banking system to meet special situations. It might also be the case that I would not want to exclude the possibility that circumstances would arise in which the Bank made requests to use the technique known as moral suasion in relation either to the commercial banks as regards their loan policies, either over-all lending policies or their lending policies in particular fields, even if it was felt these requests were going to have to remain outstanding for some time and created a serious

situation of inequity or ineffectiveness as between the commercial banks and other financial institutions. But I would not think it was necessary or, in the present circumstances, desirable for the central bank to have the power to impose loans ceilings on financial institutions, even in the absence of the constitutional difficulties that I have mentioned.

COMMISSIONER LEMAN: You do not see where the circumstances could be so exceptional as to require that strong a power to act very promptly to prevent any increase in loans? Do you think you could get that same result otherwise?

MR. RASMINSKY: If the circumstances were that exceptional, then I would imagine that the situation would be one in which it was more appropriate for government to act rather than the central bank.

COMMISSIONER LEMAN: Getting back to paragraph 17, then, where, if I might quote the submission again, you say:

> "Similarly, it would seem unwise to rule out the possibility of invoking more direct measures to control the availability of credit in an extreme situation."

Would you like to list for us those measures that you have referred to in that sentence?

MR. RASMINSKY: The measures, rather than the situation?

COMMISSIONER LEMAN: Yes, the measures. I imagine we are really talking here about a situation of extreme pressure on the economy generally, and that has been discussed before, so let us discuss the measures.

MR. RASMINSKY: The measures are of the general character, Mr. Leman, referred to at the end of the next sentence of the submission, where we say:

> "...there are limits to the extent to which and the rapidity with which interest rates can be allowed to rise, and there may therefore be times at which it is preferable to vary the cash reserve or liquid asset ratio or resort to moral suasion or selective credit controls than to allow the inflationary process to proceed without further resistance."

COMMISSIONER LEMAN: Well, we have already discussed the liquid asset ratio. We might talk about selective credit controls. One that has been mentioned to us before is the fact that consumers generally were deemed rather insensitive to movements in interest rates. Therefore, do you feel the need for a stand-by power to impose restrictions on the use of consumer credit?

MR. RASMINSKY: No, I would not wish to request that the Commission would consider recom-

mending such a power for the central bank.

COMMISSIONER LEMAN: How about the next one that has been listed here; that is, the regulation of margin operations for stocks and securities?

MR. RASMINSKY: There again, apart from the constitutional questions, I would not like to suggest that the central bank should be empowered to impose margin requirements. On these matters of selective credit controls, the central bank operation is essentially a mass quantitative operation, which need not give the central bank any powers to take decisions affecting the qualitative distribution of credit to different types of borrower.

If it were thought desirable in the public interest that public control of that type should be exercised to guard against excessive amounts going to certain types of borrowers and to ensure that adequate amounts go to certain other types of borrowers, I would assume that this would be for Parliament to decide rather than the central bank.

COMMISSIONER LEMAN: So, it is not because you are necessarily convinced it would never be needed, you feel someone else should do it?

MR. RASMINSKY: I am certainly not necessarily convinced it would never be needed; in fact, somewhere in the submission I believe we have indicated there could be circumstances in which such controls or such powers might be useful.

MR. LEMAN: Don't these exceptional circumstances we have talked about arise sufficiently suddenly that the standby approach would be necessary rather than having to go to Parliament at the time?

MR. RASMINSKY: If a situation does arise, Mr. Leman, in great force, suddenly, and the situation is one in which the public interest is seriously endangered and this action is needed to counteract it, then I would conceive that to be a situation in which even without statutory power to do so the central bank would, mainly through its relationship with the chartered banking system, take steps to try to bring the situation under control, and I think that I could add that I think that in the situation of the type that I have described that the central bank could count on the cooperation of the

banking system to do so.

COMMISSIONER LEMAN: How about the ability of Canadian residents or junior governments, that we have heard so much about, their ability to go to the foreign market for borrowings; do you regard that as something that would need some kind of a standby control?

MR. RASMINSKY: No, I don't. The borrowing of funds abroad by residents of Canada or junior governments, like the transfer of funds to Canada by the banks themselves from time to time through changing their net foreign asset position, cannot create additional cash for the monetary system or the banking system as a whole.

Notwithstanding that - such borrowings abroad and transfers to Canada -the central bank remains in control of the total size of the banking system and the total money supply. But I think that there may from time to time be problems of equity involved here, in the sense that in a situation of monetary restraint some people have access to the American market where others do not have access to the American market, but such questions are ones that I don't think central banks can deal with.

COMMISSIONER LEMAN: But these borrowings do have a direct relationship on the demand for goods and services, don't they?

MR. RASMINSKY: These borrowings affect the financial resources at the disposal of the borrowers, and which they can use for goods and services, but as I say, they do not affect the ability of the central bank to control the total size of the banking system, to

control the money supply and to use its influence to create overall credit conditions of the type that it thinks appropriate.

COMMISSIONER LEMAN: Well, there is another one here in the list we have that you mentioned in passing, at least, and it is somewhat similar to the present status of the liquid asset ratio, and I think it is by agreement with the banks, isn't it, that some limitations have been put on term lending by the chartered banks in agreement with the Bank of Canada?

MR. RASMINSKY: There have been occasions in which the Bank of Canada has requested the chartered banks to put certain limits on term lending. Any limits that there are on term lending at the present time are by agreement among the banks themselves without the participation of the Bank of Canada in the arrangements.

COMMISSIONER LEMAN: Well now, in discussing these special powers, you have made a reference to what people have come to call "moral suasion". Could you tell us a little bit about how it works in practice, how successful it is?

MR. RASMINSKY: The way moral suasion works in practice is that the Governor of the Bank meets with the executive officers of the chartered banks, expresses to them certain views regarding whatever it is he is trying morally to persuade them to do, and asks for their cooperation in enforcing those views, which might relate on occasion to the distribution of credit. There have been a number of occasions in which the central bank has expressed views. If you like, I would be able

to go over those occasions and tell you what they have been. Would you wish me to do so?

COMMISSIONER LEMAN: Yes, I think it would be interesting; that would illustrate how it works.

MR. RASMINSKY: Yes. In 1936 -- am I going back too far? Well, I will start start ten years later, 1946. I may say that many of these examples were before my time and I will not be able to tell you what precisely was in mind when these requests were made.

At a meeting with general managers in 1946, the banks were asked to restrict their holdings of Government of Canada bonds to an amount not exceeding 90 per cent of their Canadian personal savings deposits and to restrict their net earnings on such securities to a certain maximum.

In 1948, at the suggestion of the Bank, the banks reached an agreement to refrain from making term loans or purchasing corporate securities in amounts in excess of a certain limit. This suggestion of February, 1948, was withdrawn in February, 1949.

In 1951, as a result of a suggestion from the Bank of Canada, the banks agreed first to have no further expansion in their total loans under the existing conditions; secondly, to cease making term loans or purchasing corporate securities in amounts in excess of a certain sum; thirdly, to require at least 50 per cent margin in the case of loans to carry corporate stocks and, fourthly, to allow no further increases in total loans to finance companies. This agreement was extended in January of 1952 and was suspended later in that year.

Again in 1955 there was an agreement negotiated with the Bank of Canada with regard to term loans.

The minimum liquid asset ratio agreement was of this type; it was in November and December of 1955.

I think that that perhaps is enough to illustrate the character of / the subject matter covered by the exercise of "moral suasion."

COMMISSIONER LEMAN: Well, these all occurred before your time; nevertheless, I ask you if you know how this was done? Did some of the banks talk back and argue strongly against some of the suggestions by the Bank, or did they generally just nod and . . .

MR. RASMINSKY: I understand, Mr. Leman, that you will be seeing the banks. I think that the banks would really be in a better position than I to answer that question.

However, I really shouldn't leave it at that. From what I know of the matter, such suggestions gave rise to a good deal of give and take in discussion, but suggestions of this sort are not made unless there is a clear public interest in them being followed, and since the central bank by and large is somewhat reluctant to use these techniques, I think that the general experience is that the public interest is recognized by the chartered banks and after the discussion the cooperation of the chartered banks is forthcoming.

COMMISSIONER LEMAN: These are clear cases of requests made by the banks that resulted in agreement by the chartered banks to abide by certain rules for a

limited period of time.

Now, what about the effectiveness of moral suasion if the Bank should at some point feel the need to go outside the chartered bank system to try to obtain definite results.

MR. RASMINSKY: Such efforts as there have been along these lines are of a somewhat more mixed character.

In 1956, there was an approach made by the Governor of the Bank of the time to instalment finance companies, urging them to hold their receivables to the existing level over the next ten months, and no agreement was reached.

There was also a meeting in 1956 with the representatives of department stores, and the idea was put forward that the department stores might either put a quantitative limit on department store credit or agree to restrict the maximum terms of such credit, and no agreement was reached.

There have been occasions when discussions have taken place with the stock exchanges with regard to the use of stock exchange credit, and there -- though no specific agreement as to what should be done was reached -- there was a meeting of minds and the Bank was satisfied with the results of these conversations.

COMMISSIONER LEMAN: Well, if I might turn now to --

COMMISSIONER BROWN: May I question at this point?

COMMISSIONER LEMAN: Yes, go on.

COMMISSIONER BROWN: May I give the Governor the opportunity of answering this question, if he feels like answering it. Have you had any experienee with the use of moral suasion?

MR. RASMINSKY: Yes.

COMMISSIONER BROWN: Has it been ---

MR. RASMINSKY: I have been satisfied with the results, yes.

COMMISSIONER BROWN: I gather that you prefer not to ---

MR. RASMINSKY: I think that the experience is so recent -- I mean, it is obviously an experience within the last eighteen months, Mr. Brown, and if you don't mind I would prefer not to discuss the details.

COMMISSIONER LEMAN: If I might turn now, Mr. Rasminsky to your comments on page 22 of your submission of yesterday, your comments on the bank rate. First of all, at the very end of the paragraph -- and you end at page 23 -- you say:

> "If we develop a mystique about Bank Rate changes under which every change is supposed to be saying something about the future, we will, I think, be creating false expectations and complicating the normal use of this instrument by the central bank."

So, would you explain to us what the normal use of it is if it is not meant to operate, apparently, as a signal?

MR. RASMINSKY: There are occasions, of course, in which I would agree that it is meant to

operate as a signal, and we have had one such occasion with the initial fixing of the bank rate at 6 per cent but I would,Ithink, regard the normal use of the bank rate as indicating a changing view of the central bank as to the appropriate upper level of very short term rates. I think that this is essentially what the bank rate does; it puts a tentative ceiling -- not, perhaps, an absolutely rigid ceiling, and perhaps over short periods of time short rates might go above the bank rate without the central bank feeling under any compulsion to adjust the bank rate -- but it does put a tentative ceiling on rates.

Of course, if you look at the movement of the bank rate over a period of time you can detect a progressive movement, a progressive development of conditions of ease if the bank rate is going down, or a progressive tightening.

COMMISSIONER LEMAN: Who are the people you feel have got to be too mystical about this? Not the chartered banks themselves or the investment dealers, but what sector do you feel has tended to misinterpret what this value would be as a signal?

MR. RASMINSKY: My friends around me remind me that I said "if" in the statement; that "if we develop a mystique about bank rates," and I think that that may relieve me of answering:

COMMISSIONER LEMAN: Well, let me phrase my question in a fairer way. Don't you think that with the use of the bank rate , a fixed bank rate system over time,that the chartered banks and the non-banks would

learn to interpret it properly?

MR. RASMINSKY: Yes, I do; I hope so, Mr. Leman, and I am trying to help a bit in that direction by indicating early in the game that people must not expect too much of the bank rate, that they must not read too much into changes in bank rate, but I quite agree with you that in the course of time it is reasonable to expect that people will interpret changes properly.

COMMISSIONER LEMAN: During the lunch hour today I read a speech that was delivered this morning in Montreal by a banker, in which the implication was that there might develop a quite subtle ability to interpret the significance of changes in the bank rate from time to time.

MR. RASMINSKY: You must have read a different speech from the one that I read.

COMMISSIONER LEMAN: Your comments, if I can go back to page 22, do not express a definite preference for the fixed bank rate or the flexible bank rate, as I read them.

MR. RASMINSKY: Well, Mr. Leman, I expressed my preference by fixing the bank rate. I regard the arguments about the relative merits of a fixed bank rate and a floating bank rate as over, as far as I am concerned.

Now, if the Commission, having studied the matter and after having heard various witnesses, should reach the conclusion and should make a recommendation that we revert to the system of a floating rate, or go on to some other system, then that is certainly something that the central bank would wish to take into consideration and give the most serious attention to, but so far as I am concerned this is a piece of history. We are on a fixed bank rate, and I have no intention at the present time of changing that system.

COMMISSIONER LEMAN: Quite apart from movements in the fixed bank rate, what other signals

do you think the Bank could usefully give to the market of its own thinking or of its own appreciation of the situation?

MR. RASMINSKY: The easiest method, I think, of communicating ideas is that of using the English language. If the central bank has something that it feels able to say, and if it wishes to say something in order to give some indication as to its views as regards the future, then I think the most natural thing for the central bank to do is to make a speech or to issue a statement. I do not think that the interpretation that we want to give to bank rate as something that is not at all times a signal deprives the central bank of the opportunity of communicating any views that it holds to the public.

Essentially, of course, the way the central bank communicates its ideas to the public is through the monetary policy that it pursues. There is no signal which is really more immediately apparent to the banking system than a flush cash position, or a tight cash position. These two methods -- monetary management on the one hand, and the use of language on the other -- seem to me to provide the central bank with adequate means of communicating its views to the public.

COMMISSIONER LEMAN: Did I understand you correctly earlier to have expressed the opinion that there are times when you do not want people to make too much of what the central bank is doing

at that moment, and that you would expect them to form their own judgments as to what is the proper conduct to follow at that time and not be too slavishly trying to interpret what is in your mind; that they should try to form their own opinions?

MR. RASMINSKY: Yes, I would certainly like to see that done.

COMMISSIONER LEMAN: Unless there is something more on this point I would like to change the subject a little bit.

COMMISSIONER BROWN: I would like to ask something here to clarify my mind. You have probably dealt with it already, but I would like to have it more closely in context. You say:

> "The principal advantage of a fixed Bank Rate over a flexible Bank Rate lies in the element of stability that it can give to money market rates by tentatively placing an upper limit on their movement."

You do not say anything there about the use of it as a signal in moving upwards. I would like to get it clear whether you think it is useful as a signal of intention, prospective fact, or recognition of an existing situation.

MR. RASMINSKY: I think in the normal course of events, Mr. Brown, that the bank rate registers what the situation is. The situation gradually develops as a result of the various forces

operating in the credit system, including central bank policy. The central bank may encourage the development along the lines of market forces, or it may be resisting or discouraging it. Out of the combination of these factors you get a certain credit situation which, for shorthand, you can say is reflected in the level of short-term rates, and those developments take place over a period of time.

At a certain point in the process -- a point which is necessarily arbitrary, but which is chosen by the central bank -- it seems to me that the central bank registers that this development has taken place and that this development is in accordance with its views as to what is appropriate. It registers that by changing the bank rate.

COMMISSIONER BROWN: In other words, it underlines an opinion, rather than signalling.

MR. RASMINSKY: Yes, rather than signalling. I would conceive, Mr. Brown, that this is the normal use of the bank rate. This conception is admittedly based on a very limited experience with bank rate, but that is how I think about bank rate at the present time.

COMMISSIONER GIBSON: Mr. Rasminsky, I take it from what you say that there are relatively few occasions when the central bank wants to give a clear signal -- a strong signal or a clear signal?

MR. RASMINSKY: I think that is correct, Mr. Gibson, yes.

COMMISSIONER GIBSON: In other words, the standard procedure is not clear signals. Is that a reasonable statement?

MR. RASMINSKY: It may be reasonable but ---

COMMISSIONER GIBSON: If these statements were clear all the time everybody would know what is going to happen, and there would have to be a perfect state of knowledge on the part of the central bank, and a full response on the part of the financial community.

MR. RASMINSKY: Of course, the difficulty, Mr. Gibson, is not that everybody would know what is going to happen. The real difficulty with clear signalling is that the central bank does not know what is going to happen. It is not that the central bank wants to play it in a cagey way and refuse to take the public into its confidence as to what the future holds. Unfortunately -- and I might say that I wish it were otherwise ---

COMMISSIONER GIBSON: Is it not true to say that the central bank most of the time does not know, and is making its best guess like everybody else is?

MR. RASMINSKY: That is right, and it is continually revising the views it holds as additional information becomes available, and as the situation unfolds.

COMMISSIONER LEMAN: May I turn to something else now?

MR. RASMINSKY: Surely.

COMMISSIONER LEMAN: You have already expressed before us the thought that you did not feel that the operations of the near banks impeded in any way the normal function of monetary policy as you saw it. I do not want to raise constitutional problems here -- a few moments ago you said one of the objections to such a proposal was that there was a basic constitutional problem involved, and there might be a slight one in this respect -- but let us abstract that from it, and discuss the thing as if it could be solved even if it does raise a constitutional problem, and I am thinking of the idea of bringing the near banks within the system to the extent of having them hold deposits with the Bank of Canada, and, perhaps, working to some statutory cash ratios too. What are the advantages or disadvantages of this?

MR. RASMINSKY: The near banks, of course, do hold cash like any other credit institution. If the Commission or Parliament wished to provide that this cash should be held with the Bank of Canada instead of with a chartered bank, or wherever it is held at the present time, I would see no reason from the point of view of the Bank of Canada for resisting such a proposal. The point that I was concerned to make in connection with this problem was that I did not think that the existence of near banks, or the fact that they were not banks in the sense that they were not members

of the fractional reserve system, constituted a hindrance to the effectiveness of monetary policy.

COMMISSIONER LEMAN: And it would follow from that that you do not think there would be, therefore, any particular advantage to monetary policy from having them subject to those regulations?

MR. RASMINSKY: That is right, yes.

COMMISSIONER LEMAN: And, by the way, I should mention for the record, that what I have in mind in mentioning these institutions are those that accept demand deposits from the public. Let us reverse the propositinn now. Would you comment on the advantages or the disadvantages of giving such institutions the right to deal with the Bank of Canada in that way; to have their clearings handled through the Bank of Canada and having them hold deposits with the Bank of Canada? I am asking you now to consider the position if they were given the right to do that if they wished to do it.

MR. RASMINSKY: In connection with the clearing, what one is involved with is the whole complicated question of how the clearing system operates, and what charges are made on various items including the cheques drawn on the demand deposit accounts in near banks that are put through the clearing system. These are matters involving cost which are ones which the Bank of Canada is not involved in, and in regard to which I would not wish, therefore, to express any view. But, if as a result of negotiation between those concerned

the clearing of items drawn on near banks could be facilitated through the operation of clearing accounts by them with the Bank of Canada, I would see no reason why we should not operate such accounts.

COMMISSIONER LEMAN: One thing that might induce them to do so would be if the Bank of Canada was willing to pay interest on deposits. Does that involve any other disadvantage than just the cost of the interest paid? Does it have any other implications?

MR. RASMINSKY: The payment of interest on deposits?

COMMISSIONER LEMAN: Yes.

MR. RASMINSKY: Yes, I think that the interest on deposits does have other implications. I do not see how the Bank of Canada could pay interest on the deposits of one class such as that of the near banks without paying interest on the deposits of others. If the Bank of Canada were to pay interest on the cash reserves maintained by the banks then it would lose its leverage over the employment of cash. What leads to the employment of surplus cash provided by the central banking system is the fact that, as Dr. Mackintosh said before, they prefer to earn money rather than not to earn money, and if interest were paid on the deposits of the chartered banks that powerful force would be eliminated or reduced.

COMMISSIONER LEMAN: It might be re-

duced but ---

MR. RASMINSKY; You will appreciate, apart from this consideration, that under the Bank of Canada Act the Bank of Canada is not empowered to pay interest on deposits.

COMMISSIONER LEMAN: I realize that, but we are looking into other things that might be done.

MR. RASMINSKY: Yes, quite so.

COMMISSIONER BROWN: I wonder if I could go back to the previous topic and that is on the question of near-banks. Near-banks are holding an increasingly large proportion of the dollar assets that are subject to checking, but I wonder if you could just tell us how in judging the money supply in Canada you take these into consideration?

MR. RASMINSKY: Statistically, the deposits in the near-banks are not included in our measurements of the money supply. We define the money supply to mean currency in the hands of the public, and deposits at the chartered banks, so that the direct answer to your question is we do not take them into consideration in deciding what the money supply is.

However, the Bank of Canada in carrying out its monetary policy does not aim at producing changes of any given magnitude in the money supply. The fulcrum of our policy, what we aim at, is producing, along with all the other factors operating in the market, an influence over credit conditions. This is really the basic point in the view that I expressed yesterday that the existence of the near-banks does not act as a significant restraint on the central bank in producing the credit conditions of the type that it thinks appropriate.

It has a sufficient large sector to operate on in the chartered banking system to count on that fanning out and affecting interest rates and non-price terms of credit outside the banking system. It would, of course, from our point of view, be useful to have mor

information than we have at the present time regarding the assets and liabilities of various types of financial intermediaries, trust and loan companies, and so on. We would like to have more information.

COMMISSIONER BROWN: If things remained as they are at the moment; that is, if the system remained as it is at the moment and the near-banks' holdings of total assets, or fraction of assets, continued to increase, at what point would you start to become worried?

MR. RASMINSKY: Well, one would commence to become worried, for reasons of monetary control, at the point at which the base on which you had to operate, that is the chartered banking system, was so small that you could not through operating on that base exercise the influence that you wanted to operate on credit conditions.

There might be other reasons for looking at near-banks. There may be problems of equity that are involved here, and I am not addressing myself to these problems. I express no view on these problems.

COMMISSIONER BROWN: You have answered my next question.

MR. RASMINSKY: Well, I am glad I got the answer in. The only thing that I feel competent to express a view on is the effect of the existence of these institutions on the ability of the central bank to influence credit conditions. I think the other view is really based on the notion that what monetary control means is control of the availability of the credit, so that one might say, "Well, if the non-banking part of the credit system is growing quite rapidly and th

central bank controls the money supply in a period of strong economic expansion so that someone is turned down at a chartered bank and then goes to another source of credit and gets the money" -- then the argument would run, "Well, the fact that he is able to get the money at some other source demonstrates that monetary policy is ineffective, that it has been frustrated."

That is not the situation at all as I look at it. In the situation I have described the commercial banks will be selling securities to endeavour to meet their loan obligations. They may be raising their deposit rates to try to retain deposits. The non-banking financial intermediaries, to protect themselves against losing deposits, will be raising their rates, and to preserve their own profit margins they will be obliged to raise the price that they charge for credit.

In our view the price of credit is an important factor in determining the use of credit, and as long as the central bank can effect the price of credit, and as long as it can feel reasonably confident it does that, associated with the rise in the price of credit will be a stiffening of the other terms of credit, that other lenders will become more selective, will require larger down payments, will insist upon other non-price features of an increasingly onerous character, -- as long as that is the situation then the position, as it seems to me, is one in which the central bank is able in a period of monetary restraint to make its influence felt throughout the credit system.

COMMISSIONER GIBSON: In the final analysis does not increased costs boil down to increased availability? Are you not saying that as the cost of credit goes up and works through the system it will finally restrain the demand?

MR. RASMINSKY: In the ordinary course, Mr. Gibson, you would expect the cost and the availability factors to go together, and to go in the same direction. In other words, as credit becomes cheaper, as the system becomes more liquid, then, the standards on which lenders insist becomes less onerous from the point of view of the borrower, and in the opposite direction, too, I would expect normal price and availability of credit to move in the same direction.

COMMISSIONER GIBSON: Have you not almost been saying that as the price increases and as people reach out and get credit in other ways, that this does result in a lessening of availability?

MR. RASMINSKY: Yes. I made a misstatement before, one that could be misinterpreted, when I said I would expect price and availability to go in the same direction. What I meant was that at the time the price would increase, the non-price factors connected with credit would also stiffen and the availability of credit would be reduced.

COMMISSIONER BROWN: You expect to operate more directly through the price mechanism than through the availability?

MR. RASMINSKY: That is right.

COMMISSIONER BROWN: Just to fly a bit of a

kite, we discussed this morning briefly the influence of a differential reserve ratio on demand deposits and on savings deposits. Just let us kick around the thought for a moment that if at some stage, and over-looking the constitutional problems that you and Mr. Leman mentioned, it was thought desirable that other intermediaries carrying on other banking functions, now classified as near-banks, were to be required to have cash reserves at the Bank of Canada, would there be some virtue in this, considering this differential reserve ration on the basis that they might be at the same ratio as was requir d against savings deposits?

THE CHAIRMAN: Suppose we rise for about five minutes or so?

MR. RASMINSKY: Good.

THE CHAIRMAN: You have been in the witness box for a prolonged period.

--- Short recess.

THE CHAIRMAN: We have an unanswered question.

MR. RASMINSKY: Mr. Chairman, having been saved by the gong I am now able to give an inconclusive reply. I think the answer to Mr. Brown's question is that Parliament would have to decide at the time on the terms under which the near-banking institutions, or any particular group of near-banking institutions, came into the fractional reserve system.

COMMISSIONER BROWN: I think that is understood, Mr. Rasminsky.

MR. RASMINSKY: Those terms would not necessarily, I suppose, be the same as the terms on which the chartered banks are in the system. Under the Quebec Savings Bank Act, the institutions covered by that act are required to hold 5 per cent of their deposits in the form of cash, either with the Bank of Canada or elsewhere. A consideration in connection with the postulated membership of the near-banks would certainly be the character of their liabilities, and the fact the mix of their liabilities is different from that of the chartered banks would undoubtedly mean they have less in the way of demand deposits and more in the way of long-term deposits and debentures outstanding, and that might lead Parliament to decide that a different cash reserve ratio was appropriate in their case.

COMMISSIONER LEMAN: Mr. Chairman, I have a question I should like to ask Mr. Rasminsky before we change this general area of discussion. I should like to refer to page 14 of your submission of yesterday where you say that you would like to stress the importance of plenty of effective competition in the market for the purposes of having effective monetary policy. Now, if we talk about the chartered banks sector all by itself, do you see any practical or effective ways in which the nature of the competition between the chartered banks themselves could be changed to bear more upon the question of rates on loans and rates on deposits rather than letting it bear more on service than it has in recent times?

MR. RASMINSKY: I find that a very difficult question, Mr. Leman. I do not really think I would care now, at any rate, to express any views on this question.

COMMISSIONER LEMAN: Because elsewhere, on page 19, you make a reference to a good deal of rigidity in chartered bank lending and deposit rates. I suppose you might consider that as one of the market imperfections that you earlier referred to.

MR. RASMINSKY: Yes, I do. I thought your first question referred to price competition within the banking system.

COMMISSIONER LEMAN: Yes, it did.

MR. RASMINSKY: The rigidities that I referred to are, on the whole, uniform rigidities.

COMMISSIONER LEMAN: That does not necessarily make them better?

MR. RASMINSKY: No, I quite agree with you.

COMMISSIONER LEMAN: All right, I shall drop that question.

MR. RASMINSKY: Thank you.

COMMISSIONER GIBSON: Mr. Chairman, may I go back to the matter of the bank rate? I understood you to say, Mr. Rasminsky, that the matter of a fixed rate, as far as you were personally concerned, was one of history at this time?

MR. RASMINSKY: Right.

COMMISSIONER GIBSON: May I ask you if you are referring simply to the new fixed rate which started, I believe, last June, or are you referring to a system of a fixed rate with a floating rate as well?

MR. RASMINSKY: I meant the reference to be to both, Mr. Gibson, but, as I say, if the Commission had any views on either this dual system or any part of it, I would certainly pay the closest attention to the views of the Commission.

COMMISSIONER GIBSON: Are there any difficulties about the dual system as it now exists?

MR. RASMINSKY: I have not encountered any difficulties with the operation of the dual system.

COMMISSIONER GIBSON: There are no technical problems?

MR. RASMINSKY: No technical problems that have arisen. The dual system leaves the money market situation undisturbed. It provides the money market dealers with the assurance that they can obtain central bank credit at a level which is in some sort of a reasonable relationship to the money market yields, to the treasury bill rate, and it is a system which I think is helpful to the money market. I feel that the system provides the central bank with a little more flexibility than a unitary bank rate system would provide it with as regards the timing of changes in bank rate.

One can imagine a situation where the central bank would be prepared to permit or encourage developments to take place in the short money market involving a reduction in the yields of short-term securities, but was not prepared for some time to put its imprimatur, so to speak, on these developments by bringing down the bank rate to what would be regarded

In other words, the bank rate might on occasion be high in relation to short-term rates, and an advantage that I saw in this dual system is that one could permit such a situation to develop without putting the money market dealers in a position where they had to obtain central bank credit at what would really be penal rates. This is the general philosophy of the dual rate system, and so far it has not involved any difficulties. If it should involve difficulties we would, of course, have to reconsider it, as to whether the system should not be changed. However, as of now I have no plan or intention to change the system.

COMMISSIONER GIBSON: One of the suggestions made to this Commission was that the idea of a floating bank rate might be considered with a variable spread over the treasury bill rate. In other words, if the bank wanted to give a signal to increase or decrease the spread over the existing credit rate. Did you consider that in thinking this over?

MR. RASMINSKY: That was actually the system that was in force from 1956 until June of 1962.

COMMISSIONER GIBSON: It was not a variable spread.

MR. RASMINSKY: It was a variable spread in the sense that when the system was announced -- I think I am right in saying this -- the central bank reserved the right to vary this spread. There was no guarantee under that system that the spread between

the bank rate and treasury bill rate would always remain at a quarter of one per cent.

COMMISSIONER GIBSON: But it did, in fact, did it not, throughout the period?

MR. RASMINSKY: It did, in fact, remain at a fixed spread.

COMMISSIONER GIBSON: Do you see any merit in that system?

MR. RASMINSKY: Before I answer the question, Mr. Gibson, may I quote from the press release of November 1st, 1956?

COMMISSIONER GIBSON: Yes?

MR. RASMINSKY: The Bank said, after saying a lot of other things:

> "If at any time it appears that the Treasury Bill rate is not the best indicator of market conditions or if it is found that a different margin between market rates and Bank Rate would be more suitable, or that a change in monetary conditions should be more strikingly signalized, a change in the practice will be made and announced. For the time being, however, it is proposed, as indicated, to keep the Bank Rate at a fixed margin of $\frac{1}{4}$ of 1% above the average (Treasury Bill) rate ..."

So the system you are referring to is the one that was in force, though the Bank never exercised this

power that, of course, it had.

COMMISSIONER GIBSON: I suppose you could interpret it that way, but my impression was there was very little emphasis given to any discussion in the Bank's report, or anything else, that it might vary the spread as a signal technique.

MR. RASMINSKY: There may have been little discussion given to it, but this is the press release that was issued by the Bank at the time. You asked whether I see any merit in the floating bank rate system.

COMMISSIONER GIBSON: No, I was asking you if you saw any merit in a system of signals through varying the spread. You have answered the other question because you have put another system in which you clearly like better. It was just the idea of whether you saw any merit in a system of varying the spread in the floating rate in order to give a signal.

MR. RASMINSKY: If there was a floating rate system.

COMMISSIONER GIBSON: Yes.

MR. RASMINSKY: Yes, I would see some merit, if one had such a system. I would see some merit in varying the spread on occasions when one wanted to give a signal.

COMMISSIONER GIBSON: On the question of the existing pattern, would you like to see the general pattern of interest rates going out from the short-term market, including rates of interest that

the banks charge and receive and the near-banks charge and receive, being somewhat more responsive to bank rate?

MR. RASMINSKY: Yes, I would.

COMMISSIONER GIBSON: Would you care to elaborate on that a little?

MR. RASMINSKY: Well, I think what this comes to saying, Mr. Gibson, is that it goes back to the view that I have expressed as to the way that the fixed bank rate system operates; that it will from time to time be adjusted in line with the rates prevailing in the short-term market, and those rates are influenced by the central bank's views as to the conditions that are appropriate. I think the central bank would like to see its influence spread pervasively through the whole range of rates in the market. This would mean more variability in banks' deposits rates and more variability in banks' lending rates, and, operating in that way, more variability in the rates paid and charged by other financial institutions. I think this would be a good credit market. It would eliminate or reduce some of the imperfections represented by some of the present rigidities in rates. So that I would like to see the structure of rates more responsive to changes in bank rate . At the same time I would not put forward as a proposal the proposition that the rates in the banking system, deposit rates or lending rates, should be automatically linked to the bank rate.

COMMISSIONER GIBSON: You would not want

to see as close a relationship as seems to occur in the United Kingdom?

MR. RASMINSKY: I would not like -- and in this I think one has in mind the structure of our financial system and the number of competing intermediaries -- I had regarded that idea as a rather attractive one at one time, but having regard to these other considerations that I have mentioned, I have come to the conclusion that such a linkage would introduce an element of rigidity into the system and that it would be better if there were more flexibility and greater responsiveness on the part of the banks to the development of market rates of interest.

COMMISSIONER GIBSON: One of the disadvantages, of course, of that more or less automatic response is if you are not too sure of the change you are making you may get a bigger reaction than you want.

MR. RASMINSKY: That is quite right.

COMMISSIONER GIBSON: I was going on to another subject, if no one else has any questions.

THE CHAIRMAN: No further questions on that, thank you.

COMMISSIONER GIBSON: Mr. Rasminsky, we have had a very interesting discussion with you and a very interesting series of expressions of view from you on monetary policy, running through from the role or objectives of monetary policy, the effectiveness of techniques, and so on, always working around

the same sort of basic questions. It seems to me from what you have said, and from what our research has so far indicated, that it is reasonably clear that monetary policy does have a fairly clear and not too slow effect on financial institutions and interest rates, particularly in the short-term interest structure, with a little more lag on bank lending policies and with, perhaps, a little more lag on lending policies of other institutions. But, in any event, you can see these relationships working to quite a degree and with varying responsiveness in the financial area. It seems to me that when we come to the question of how these responses affect spending decisions, we are in the area of greatest uncertainty and greatest doubt, and we are by no means sure how quickly or just how a lot of these things work. I do not want to put words into your mouth, and if you do not agree with this kind of comment I wish you would say so, but what I would like to know is, would you be prepared to say anything more about this business of what the economist or what some of our people call a secondary lag; that is, a lag between the response of the financial institution and the real decision. Some of these lags appear long and some of them are almost indeterminate. You have said that you think by and large that monetary policies usually will be in the right direction. I would like to have some reassurance on this, because it is just possible some of these lags are pretty long; and from the little bit of work that our staff

did, some of them seem to be quite indeterminate; in other words, you could not see a sensible relationship in some areas.

I am asking you if you would care to make any more comments on this area, but let me give you an example of the kind of problem that I am thinking of in this regard. You have spoken on a number of occasions of the problems of the chartered banks' responsiveness in their lending policies to changes in cash reserves, and the lag and the flexibility here, and the differing degree of response. Does this mean that the Bank of Canada feels that the effects of tightening Bank lending policies are relatively more important than the effects of interest rate changes resulting from Bank sales of securities? In other words, does this sort of emphasis indicate a view about this secondary lag, about the kind of policies which are most effective in changing spending decisions?

MR. RASMINSKY: It is a very interesting series of questions, Mr. Gibson. If I can try to deal with the last one first ---

COMMISSIONER GIBSON: I think they all boil down to the same thing.

MR. RASMINSKY: I think that the impact of a change in the bank's lending policy and the impact of a bank's sales of securities are really tied together, that in the sort of situation which one is talking about, where there is a lot of pressure of loan demand on the banking system, the central bank will presumably --

the assumption that we are making is that the central bank will not provide the banking system with the aggregate additional resources necessary to satisfy that loan demand. This puts the banking system under pressure, to which it responds by selling securities to get the money to finance the continued loan expansion. So, these two effects -- the effect on credit conditions of the sales of securities and the effect of a more restrictive lending policy, the need to raise credit standards and to be more selective in their loans, because the banks are not able to meet the entire demand and they may be running out of liquidity and they do not relish taking the losses involved in the sales of securities -- these effects are joint and operate at the same time.

I think that our main interest in this would be to avoid drastic actions which involve extremely large sales of securities with very upsetting effects on security markets, or which involve very abrupt reversals in banks' lending policy. That can be very disturbing. It is for this reason that we think it would be useful to have a bench mark for the banks to use in producing somewhat earlier responses on lending policy.

COMMISSIONER GIBSON: It is not because you think the effect of interest rate changes resulting from the sales of securities is less significant than the effect of a tightening of lending policies, which would be the alternative to sales of securities? Do you see the point I am

getting at? I am asking you if your emphasis on this implies a judgment on whether it is interest rates or availability of bank credit which are more important factors.

MR. RASMINSKY: I think I would have to answer again, Mr. Gibson, that I think they go together, and I would not feel able to choose between the availability and interest rate. If the bank does not sell, or chooses not to sell the securities and to turn more of the loan applications away, is that the case that you are taking?

COMMISSIONER GIBSON: You expressed a judgment as between these two things that a bank may do when it has a fixed cash position and an increased demand for loans, and are you not expressing a judgment as to which is the more desirable when you try and make a more rapid response in lending policy; the bank has the alternative of selling securities, by cutting back on loans and at some point there is a question of choice here?

MR. RASMINSKY: I think that the only judgment that I am expressing there is the judgment that responses should be gradual. I don't mean to be expressing any choice as between one response or the other, but merely the judgment that abrupt changes in lending policy are worse than gradual changes in lending policy.

COMMISSIONER GIBSON: And similarly, that abrupt changes in security prices are worse than gradual changes in security prices.

MR. RASMINSKY: That is right, yes. On your first question, on the question of lags, I am interested in what you have to say about the study done by the staff of the Commission. I haven't seen the study and I would be very interested in seeing it and would be glad to comment on it when I do see it.

The matter of lags is, indeed, a difficult one. One knows that in some fields the lags in response are short enough to be capable of accomplishing the results that you have in mind. I think that this is certainly true in respect of international capital movements. There the lags seem to be reasonably short.

COMMISSIONER GIBSON: That in a sense is a financial response, isn't it, though?

MR. RASMINSKY: Initially, at any rate, it is a financial response. I know there are some who feel that the lags are so long -- that the lags in the response of varying credit conditions on the demand for goods and services -- that they are so long that there is some danger that a given monetary policy will produce adverse effects; that if the central bank sets out to tighten conditions because it thinks that the economy is going full steam ahead and going into an inflationary boom, that by the time this effect on credit conditions works its way through the economy, the economy will be in a recession, and there are some, I know, who even go so far to say that this danger combined with the "lack of intelligence" normally to be found in central banks -- and that is in quotation marks -- is so great that it would be better for the central bank to operate on the basis of some purely automatic formula. That it would be better for a judgment to be formed once and for all that the money supply should be increased at the rate of X per cent a year, and month in and month out that the central bank should take action to make sure that the money supply is increased by X over 12 per cent a month.

COMMISSIONER GIBSON: There are many at variance with this view, and I am interested in your comments on it.

MR. RASMINSKY: Well, I don't agree with any of the assumptions on which the view is based, but

I will comment only on one.

It is my judgment -- and I agree that it is only a judgment, I will not be able to prove this statement -- that the expansionary phases of business cycles are long enough and that the probable lags in the impact on credit conditions on the demand for goods and services are short enough that there is not great danger that central bank action will be adverse in its effects and that, on the contrary, there is a good chance and a chance worth taking that central bank action can be a mitigating factor in combination with other policies in restraining the excesses of expansionary periods.

COMMISSIONER GIBSON: And in postponing expenditures to a time when they might be more needed?

MR. RASMINSKY: Yes.

COMMISSIONER GIBSON: Thank you very much. Now, in this same vein, going back to the objectives we talked about in the beginning, you developed the many limitations of monetary policy, and we have been thinking of a worse one, which is knowing just what really happened. In view of this, how ambitious should we be in setting out objectives? It is a pretty elaborate series of objectives.

MR. RASMINSKY: These objectives in paragraph I of section II are the objectives of public economic policy.

COMMISSIONER GIBSON: Yes sir, I know.

MR. RASMINSKY: I don't think that we should set our sights too high; I don't think that we should

make excessive claims and I think that the general tendency is, in fact, to claim more for the effectiveness of monetary policy than is justified.

COMMISSIONER GIBSON: What I am really getting at is how closely do you think central bank and the other cooperative arms of government should attend to what the economists call the short cycle. In cther words, should the emphasis be mainly on trying to control short cycle or should you be taking a longer view of this?

MR. RASMINSKY: I think you should be doing both. I don't think that this is a choice that has to be made, Mr. Gibson.

I think that the whole combination of public policies can have a significant influence on the short cycle. I don't think that it is an accident that the cycles in the last 15 years or so have, in fact, been shallower cycles than they were before the war. I think that this is at least partly due to the compensatory effect of various types of public policy and fiscal policy and monetary policy. So, while I don't think that one should claim too much, I certainly wouldn't want to write off as insignificant and not worth going for the stabilizing effects that public policy can have on the short cycle.

COMMISSIONER GIBSON: Well, would you think that it was particularly important for a central bank to keep its eyes a little further ahead than that, admitting it might be effective to some extent, the short

cycle? In other words, from time to time you get substantial changes in economic climate which imply a sort of a different order of policy, and we had such a change, I suppose, at the end of 1957, and it began to be clearly so recognized around 1958, or so, which suggested different kinds of policies, different emphasis. Is this the area where central bank ought to be thinking particularly?

MR. RASMINSKY: I think that this is one of the areas that the central bank ought to be concerned with. I suppose one of the contributions made by public policy -- and in this connection largely by central banking policy -- to the economic recovery of Europe in the last several years was the elimination, the actions of various sorts taken to eliminate the excess liquidity from the economy that was developed by the war.

The long run, the long range attitude, is something that the central bank should have in mind at all times. I think that the central bank -- if one looks at it this way -- that the central bank should be concerned as regards its own affairs with the question as to the adequacy over a long period of time of the growth of the money supply in relation to the growth of the gross national product; that I think is something that the central bank should be concerned about. But I don't think that one thing has to be given priority over the other, and I think that the two types of preoccupation, the long run preoccupation and what the contribution

can be to economic stabilization in the short run can go hand in hand.

COMMISSIONER GIBSON: We are just about reaching our closing time, but I would like to leave you with a question that perhaps we might take up in the morning.

MR. RASMINSKY: If it is easy, I will answer it immediately!

COMMISSIONER GIBSON: It is not!

MR. RASMINSKY: If it is not, I would rather you didn't ask it!

COMMISSIONER GIBSON: Well, it is the same thing put another way. How would you judge whether or not central bank policy was successful or failing? In other words, how do you judge your failures in your business? This is a very difficult question and I wouldn't want to press you for an answer now, but it is a question of trying to get at the same old business of how effective monetary policy is and what are the standards by which you judge its success or failure?

COMMISSIONER LEMAN: The alternative is that the Governor has to work all night!

THE CHAIRMAN: We will adjourn unless you can answer right off the bat.

MR. RASMINSKY: Well, I will give Mr. Gibson the choice of two immediate answers. One would be that you do not judge it by your correspondence, and the other would be that you do judge it by appointing a Royal Commission!

THE CHAIRMAN: We will now adjourn until 9:15 tomorrow morning.

Royal Commission on Banking and Finance

THE BANK OF CANADA

Hearings held at

OTTAWA

Vol.	Date.
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Official Reporters
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Toronto, Ont.

ROYAL COMMISSION ON BANKING AND FINANCE

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Hearings held at Ottawa, Ontario, on Friday, January 11, 1963.

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THE COMMISSION

The Honourable Dana Harris Porter
Chief Justice of Ontario
Toronto, Ontario - Chairman

Mr. W. Thomas Brown, M.B.E.
Investment Dealer
Vancouver, British Columbia

Mr. James Douglas Gibson, O.B.E.
Banker
Toronto, Ontario

Mr. Gordon L. Harrold
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Mr. Paul H. Leman
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Montreal, Quebec

* Mr. John C. MacKeen
Corporation Executive
Halifax, Nova Scotia

Dr. W. A. Mackintosh
Vice-Chancellor
Queen's University
Kingston, Ontario

- - - - -

Mr. H. A. Hampson - Secretary

Mr. Gilles Mercure - Joint Secretary

* Absent

Ottawa, Ontario,
Friday,
January 11, 1963.

--- At 9.15 A.M. the hearing resumed.

THE CHAIRMAN: I declare the meeting open for discussion.

COMMISSIONER GIBSON: Mr. Rasminsky, do you wish at all to pursue the subject we ended with last night? I had asked you if you could say anything about how one would measure failures and successes of monetary policy. You gave two very appropriate answers but they were not quite full ones.

MR. RASMINSKY: Mr. Gibson, had you asked me the question this morning instead of last night I would have had a better night's sleep and you would have had a better answer. The question you have put is, in fact, an important, meaningful question. It is also a frustrating one. I suppose with respect to monetary policy, as with respect to anything else, what one means by success is the degree to which it achieves that which it is capable of achieving, and consequently I suppose the starting point in answering your question would have to be a view as to what the potentiality of monetary policy is.

If one had the opinion that monetary policy was a panacea which could cure all ills, then the test of success would be the behavior of the economy. If the economy behaved well you would decide

you had a good one, and if it behaved poorly you would decide you had a poor monetary policy.

I imagine it will come as no surprise to you that that is not the view I take. I think that monetary policy has to be regarded as one element in the whole mix of public policies which is brought to bear on a situation which includes many elements, some of which are susceptible to influence on the part of public policy and some of which are not susceptible to great influence on the part of public policy.

In appraising success one is faced with the difficult job of endeavouring to decide whether within this mix of other policies which at any given moment of time the central bank has to take as given though it may be trying to change the mix -- whether within this mix monetary policy has done its part, given the real external conditions.

This is a job worth trying to do, continuously to form these appraisals. It is a job that requires a good deal of work, a good deal of judgment, the use of such analytical tools as one has. I think that this is the way it is done. I do not think, viewing the role of monetary policy as I do, that there is any single or even double criteria that can be taken to determine what the degree of success has been.

COMMISSIONER GIBSON: I suppose our monetary policy is fairly similar to that in the United States, and if economic conditions are fairly

satisfactory in both countries then this is a reasonable state of affairs. Do you consider it in part by looking at the difference between the monetary policy here and the monetary policy across the line, and then endeavouring later to satisfy yourself as to whether those differences were justified? In other words, is what the Americans do an important benchmark?

MR. RASMINSKY: Yes. I am very glad you mentioned that, for that is a point of such importance that I should have included in my reply, not perhaps in the precise form in which you have put it, but one of the elements in our situation is our relationship with the United States. It crystallizes, in a sense, in the form of capital flows as well as trade flows, and in looking at the success or otherwise of monetary policy it seems to me that one must at all times have this relationship in mind.

COMMISSIONER GIBSON: Is it fair to say that when we deviate substantially from the sort of policies being carried on, particularly in the United States, we usually have a pretty good reason for it?

MR. RASMINSKY: Yes, that is a very fair statement, Mr. Gibson.

COMMISSIONER GIBSON: Are there any other questions along this line?

COMMISSIONER BROWN: I am probably wrong in this and perhaps you can correct me --

MR. RASMINSKY: I thought it was ~~lese~~

majesty to correct a member of a Royal Commission.

COMMISSIONER BROWN: Do not hesitate. I am wondering whether in retrospect you consider the timing of moves that you have made in relation to the phase of the business cycle as they show up in the later statistics? In other words, presumably the shorter that you can get these lags between the facts as they exist, the moves that you make and the effects that you have, presumably you have a greater opportunity to be right?

MR. RASMINSKY: Yes, I quite agree with that. The more information one has and the more up-to-date information one has, the more is one likely to be able to narrow the range of error in the judgment one forms as to what the economic situation is and as to what the economic prospects are, and therefore as to the type of monetary policy which is appropriate.

COMMISSIONER GIBSON: Do you ever go back over the years and sort of draw a monetary policy that you would have pursued if you had known the things that were going to happen?

MR. RASMINSKY: I have been so busy pursuing monetary policy in the last year or two that I have not been able to devote much time to going back over the years, Mr. Gibson.

COMMISSIONER GIBSON: This is an exercise which I think some of our people tried a little, going back and seeing what in the circumstances would have been the best thing to do, and then measuring against it what was done.

MR. RASMINSKY: Yes. I did not mean to suggest by my reply that it was not an exercise which was worth pursuing. I took it your question was addressed to me personally.

COMMISSIONER GIBSON: I am trying to get an understanding of how you measure failure and success, if there are any real, satisfactory measures?

MR. RASMINSKY: Have any ideas of such a measure occurred to you, Mr. Gibson?

COMMISSIONER GIBSON: That is the only kind of approach I can think of, and of course you do it with the full benefit of hindsight and you are not even certain then, but, at any rate, you have what happened in front of you, and this is a considerable advantage compared with the conditions under which you actually operate.

MR. RASMINSKY: Yes. I am sure that this exercise you speak of, looking back and trying to form judgments as to what was done right and what was done wrong, and what one with the benefit of hindsight would do -- I am sure that that sort of thing is worthwhile.

COMMISSIONER GIBSON: If none of the other Commissioners wish to follow this subject further ---

COMMISSIONER LEMAN: There is one point I should like to go back on that was discussed yesterday, Mr. Gibson, if you are through on this.

COMMISSIONER GIBSON: Yes.

COMMISSIONER LEMAN: In answer to a question I asked yesterday about the idea of the central bank paying interest on the statutory deposits of the chartered banks, I believe that the Governor contended that this would weaken a little bit the leverage of the central bank on the chartered banking system. Would that still be true, sir, if it were limited to the minimum deposits that have to be carried by statute, or would it then become only a matter of cost to government, if any excess cash reserves would not draw interest, but the minimum statutory reserve would draw interest?

MR. RASMINSKY: In that situation the argument that I made yesterday would not apply, for the point of leverage is on the excess cash that there is in the system. I think that the considerations involved there would be partly one that you mentioned, the effect on the distribution of earnings as between the private banking system and the public. Another consideration would be what the customary practices in this field were. The deposits with the Bank of Canada are demand deposits, and if it were the general custom to pay interest on the demand deposits then this would certainly be a consideration which would be appropriate for the central bank to take into account. Apparently I misunderstood your question yesterday.

COMMISSIONER LEMAN: That may be because my question was not quite precise enough yesterday.

MR. RASMINSKY: You could, of course, in

a sense carry the thought of the Bank paying interest on that portion of our sight liabilities which takes the form of deposits with us further and suggest that we should pay interest on our outstanding note circulation as well.

COMMISSIONER BROWN: I am just wondering, Mr. Rasminsky, how logical it is to call a statutory deposit a demand deposit?

MR. RASMINSKY: It is a demand deposit, Mr. Brown.

COMMISSIONER BROWN: But it has to be kept there. You cannot demand it. That is what I mean. It is not logical.

MR. RASMINSKY: It has to be kept there on the average. It is not fixed day-to-day.

COMMISSIONER LEMAN: If the public's deposits in the banks go down, of course, they can draw down their deposits with the Bank.

MR. RASMINSKY: You mean, if there is an increase in the total circulation?

COMMISSIONER LEMAN: No. I say that if the deposit liabilities of a given bank go down, then they can immediately draw down their deposits with the Bank of Canada.

MR. RASMINSKY: That is right. That would constitute a shift of deposits within the banking system. There always are such shifts taking place, clearing balances, which result ultimately in a transfer of deposits from one account with us to another account with us, yes.

COMMISSIONER GIBSON: Mr. Chairman, perhaps we might go on to another area, the subject of debt policy or debt management. In section 3, paragraph 10, and preceding paragraphs, you say in effect that if monetary policy wishes to influence directly the level of structure of interest rates, the virtual fusing of monetary policy and debt management operations would be required.

I am telescoping this a little, but I think that is the meaning. Might I ask you first how far our monetary policy and debt management operations are not fused now? There is a good deal of evidence of close co-operation in terms of consultation in respect of new issues, in terms of participation of the Bank in treasury bill auctions, the co-operation of the Bank and the Department of Finance in relation to advanced refunding, and so on. There are a lot of things which indicate a high degree of co-operation.

MR. RASMINSKY: Yes, indeed there is a high degree of co-operation, Mr. Gibson.

COMMISSIONER GIBSON: Is it something approaching fusion?

MR. RASMINSKY: What would you mean by fusion, Mr. Gibson?

COMMISSIONER GIBSON: Well, you used the term, Governor. You said that if monetary policy wanted to influence directly the level or structure of interest rates, the virtual fusing of monetary policy and debt management operations would be required.

MR. RASMINSKY: I would say that what you have now is co-operation and co-ordination without fusion. In using the term "fusion" what we had in mind is that there would be a single source of decision, a single source of authority with regard to both of these operations, that they would be carried out as a unitary operation, and one can think of certain central banks where that is done.

These are central banks whose practice is at all times to operate directly in the long-term market. That is not the situation here, and consequently there is not fusion of debt management policy and monetary policy here.

With respect to debt management policy, the decisions on the terms and conditions of new issues, and the other factors involved in debt management policy as we have defined it at the beginning of our submission on that subject, are taken by the Government of Canada, and the Bank acts as fiscal agent and adviser to the government, whereas the decisions on monetary policy are taken by the Bank.

COMMISSIONER GIBSON: In other words, because monetary policy puts a good deal of emphasis on operations at the short end of the market for open market purposes, and cash management and debt management puts emphasis on the whole structure, and particularly the medium and the long, if you like -- or just as much the medium and long as the short, then they are two separate functions. Is that a fair

statement?

MR. RASMINSKY: I think they are separate functions, Mr. Gibson, because they are set up as separate functions. That is the structure that we operate, that the decisions with regard to the characteristics of government debt issued, the terms to maturity, rate of interest, the callability, the possible convertibility into other issues -- these decisions are taken by the government, whereas decisions with regard to monetary policy are taken by the Bank. Obviously the two things are inter-related, and there are many points of contact quite apart from the fact that the Bank is the fiscal agent and adviser to the government and acts as such in connection with public debt transactions.

COMMISSIONER GIBSON: I understand that.

What I am trying to get is, why shouldn't they be inter-related? What are the reasons why the monetary policy has a little different slant in thinking about interest rate structure than has debt management policies? Let us look at it, for example, from the standpoint of debt management policies: is there a conflict between debt management and monetary policy when interest rates are high, or are rising rapidly?

MR. RASMINSKY: No, on the contrary -- you mean, need there be a conflict between debt management policy and monetary policy when interest rates are rising?

COMMISSIONER GIBSON: Does there tend to be a conflict?

MR. RASMINSKY: I don't think so. On the contrary, may I give an illustration of the lack of conflict?

This summer, as I indicated yesterday, the monetary policy of the Bank was largely influenced by the reserve situation and by the need to attract a sufficient inflow of capital to restore the reserves.

It was necessary, in the judgment of the Bank, in those circumstances to pursue a monetary policy which would result in a differential in interest rates large enough to attract capital including long term capital. At the time the volume of new issues put out by private borrowers and junior governments was relatively low. This made it necessary, in the light of the strong demand on the part of the general public

for government securities which developed in the summer, for the central bank to carry out a monetary policy which had the effect of supplying securities to the public from the banking system. This, of course, was the basic factor underlying the rather short lived contraction in bank assets which took place in the course of the summer.

The government, in the month of August, as part of its debt management policy, and as part of the coordinated process to achieve these objectives, issued the 5½'s of 1980, a long term security which helped to supply the securities to the market which were necessary if these general objectives were to be achieved.

So, it certainly is not the case that there is an inherent conflict of the type that you mention in your question.

THE CHAIRMAN: That was done on your advice as adviser to the government, was it not?

MR. RASMINSKY: Mr. Chairman, the government takes all sorts of advice from all sorts of people and makes up its own mind what to do. The Bank is, as I say, the fiscal agent and adviser of the government, and as such we give the government the best advice we can. The government then decides what to do.

THE CHAIRMAN: Irrespective of whose advice the government followed, the net result of that transaction was that they did follow a course which was consistent with your monetary policy?

MR. RASMINSKY: Yes. That was, I would say, an example of coordinated, not fused, debt management

and monetary policy.

THE CHAIRMAN: It seems rather a subtle distinction to me.

MR. RASMINSKY: All I can say is that it does not seem so to us, Mr. Chairman.

COMMISSIONER GIBSON: Looking at it a little differently perhaps, are not the objectives of economic stabilization, which is one of the principal objectives of monetary policy, and the objectives of debt management sometimes thought to be -- let us not say "in conflict" -- but to be running a little different course?

The traditional objective of debt management is to keep the cost of debt at the lowest feasible amount in relation to having a well balanced series of maturities. This begs a lot of questions. The need for stabilization is sometimes to raise the interest rate and sometimes to lower it.

And if debt management and stabilization were closely meshed together you might have a refunding operation at times when interest rates were relatively high. Indeed, this might be used to assist economic stabilization, to think in terms of converting debt at times of rising interest rates.

Do you see any basic difference in the approaches to debt management and monetary policy?

MR. RASMINSKY: The basic difference I see to begin with are the decisions regarding debt management, which are taken by government, and the decisions regarding monetary policy, which are taken by the

central bank.

COMMISSIONER GIBSON: I appreciate that. What we are trying to get at is the possibility of coordination and how far the two can work together on any stabilization program.

MR. RASMINSKY: May I ask you to repeat your question. I am afraid I really have not grasped what your question is.

COMMISSIONER GIBSON: The basic problem of debt management is to overcome the increasing shortening in the term of debts. Debts are always getting shorter. Sometimes you have to refund it, convert it, keep turning it over, and keep an adequate structure of maturities. This means there is a constant problem of converting debt. Is there any conflict or any difference in the approach involved in this process of converting debt and preventing it from getting too short, and the approach that is involved in the policy of economic stabilization?

MR. RASMINSKY: You have stated one of the considerations that is involved in debt management, that is, in the debt management decisions of the government. I suppose there are many considerations involved in debt management decisions of the government, some of which are quite similar to those involved in monetary policy - decisions relating to the views that are formed from time to time regarding the liquidity of the economy, the appropriateness of adding to the liquidity or subtracting from it by issuing securities that are long or short.

I suppose the government is influenced by other considerations as well, such as considerations regarding the nature of the debt, where the demand for the securities of the type is, and the consideration of costs.

The point to which you refer, the existence of a large amount of short term debt which continually has to be refunded, means that debt management policy is active, that there are frequent occasions in which there are new issues for refunding - even if there is not new money, there are new issues -- and that is one of the facts of life so far as the central bank is concerned. This is something that the central bank has to take into account. It means that at certain periods, when refunding takes place, that the monetary policy has to be conducted in the knowledge that a refunding issue is taking place.

It is not within my experience that the frequency of refunding issues constitutes a major impediment to the central bank in carrying out the monetary policy over a period of time that it considers appropriate.

COMMISSIONER MACKINTOSH: May I interject here? If I may say so, Mr. Rasminsky, it seems to me that your explanation, or your appreciation of, last summer's episode does not strike me as quite correct.

You say it illustrates no conflict. Well, if it just happened that from a debt management point of view it suited the government to launch a long term issue at that rate, then I think you were very lucky.

I took from what you said that it might at other times have suited the government to issue a different maturity, and perhaps get a lower rate, but that it was possible to sort out the priorities here and suit the government's financing to the picture, including your desire to attract U.S. capital and to put securities in the hands of the public; and that there wasn't any conflict between cost and monetary policy, but that it was possible to resolve the conflict in an acceptable and, I would think, a thoroughly effective way.

Surely, the government would always wish to borrow at the cheapest rate, if it could be shown that this would not bring problems in their way at a later time, but they have to think of larger considerations than just the cost of money next Wednesday. Is that not fair?

MR. RASMINSKY: I think I said in my opening statement before the Commission, Dr. Mackintosh, in connection with public policy decisions, as in connection with most other decisions, there are at ~~all times~~ conflicts of considerations.

COMMISSIONER MACKINTOSH: Yes.

MR. RASMINSKY: And that the consideration of cost may at times be in conflict with the consideration of appropriateness in terms of economic policy. I do not think there is anything unusual about the situation. At one time or another I suppose the government would lay more weight on the consideration of cost; and at another time it may lay more weight on the public policy consideration.

COMMISSIONER MACKINTOSH: I thought this was an admirable illustration of the way in which policy was coordinated. It was just what I understood your statement to be a few minutes ago, that this was an illustration that conflict need not arise between debt and management ...

MR. RASMINSKY: Yes.

COMMISSIONER MACKINTOSH: Rather, I thought it was an illustration that conflict did arise, as you said in your earlier statement, but that these things could be resolved into an effective policy in terms of the situation as you faced it.

MR. RASMINSKY: With great respect, Dr. Mackintosh, I think I would stick to the statement I made. I think the point of view that you are putting forward would be one that I would subscribe to if it were the case that at all times the only appropriate consideration for government in respect of debt management was cost. But I would not subscribe to that view. It seems to me that is one of the considerations, and an important one, but not by any means the only consideration.

Another consideration that is appropriate for the government to have in mind, and that it does have in mind, in determining its debt management is the effect of the characteristics of its new issues on liquidity in the economy, and on credit conditions in the economy.

COMMISSIONER MACKINTOSH: I think we are perhaps differing a little. I was not talking about any conflict of view between the government and the

Bank.

MR. RASMINSKY: Neither am I.

COMMISSIONER MACKINTOSH: Because the government has other responsibilities than debt management. I was simply talking about some conflict of view between those who look at debt management separately and those who look at monetary policy.

MR. RASMINSKY: There I am suggesting there are conflicting situations for government. There may be a conflict between its desire to have the lowest possible rate of interest on outstanding debt and its desire to have a structure of debt which is more evenly spaced over time, one which provides for the real needs of the economy, the needs that individuals and institutions in the economy have for long term debt, and one that helps to influence credit conditions in an appropriate way.

There are indeed conflicting considerations, but I would not agree that this means that there is a conflict between the point of view of debt management, that is, the debt management authorities, on these matters, and the monetary authorities.

COMMISSIONER GIBSON: Leaving out the government and the Bank, I am just thinking of the principle of debt management and the principle regarding monetary policy. I presume you have to wear two hats: when you are giving advice in debt management you are thinking of debt management, or are you trying to blend debt management and monetary policy together? There are different considerations which apply to each.

MR. RASMINSKY: When I give advice on debt management I give the best advice I am capable of giving, as fiscal agent and adviser to the government on debt management. It has not been within my experience, Mr. Gibson, - which, as you know, is quite limited in time - that I have felt any conflict between the advice I have given to the government on these matters and my monetary policy function.

COMMISSIONER GIBSON: Can you imagine circumstances where there might be a conflict, not between you and the government, but with you in your two capacities, one giving advice on debt management and the other in thinking of monetary policy considerations?

MR. RASMINSKY: I find it difficult to imagine such circumstances, because I believe that debt management and monetary policy are both concerned with credit considerations, and the line of policy that one would wish to follow in one is therefore going to be similar to the line of policy one would wish to follow in the other.

One can imagine a circumstance like this, perhaps; let us say that we are in the later stages of a boom, and let us assume that monetary policy is tending to be restrictive, that monetary policy is designed to reduce the liquidity of the economy and to tighten credit conditions -- in these circumstances the ideal disposition of debt management policy would be to issue long term debt rather than short term debt, but these are circumstances in which it might be difficult for government to issue long term debt because other borrowers are competing in the market and the government doesn't want to be in the position of seeming to take the money away from provinces and municipalities, and so on.

COMMISSIONER GIBSON: And would be paying a high rate, too, at that time?

MR. RASMINSKY: That is a consideration, but may I leave that aside and develop this point.

There would be a conflict, I can see a theoretical possibility of a conflict there, if in these circumstances the central bank did not have it within its power to produce credit conditions that were tight enough and the government was reluctant to help by issuing long term debt. This is a theoretical possibility, but to my mind this is only a theoretical possibility because I believe that -- in the circumstances that I have described -- that even wihtout an assist from government in the form of an issue of long term refunding issues, that it will be within the power of the central bank to produce conditions that are tight

enough for anybody's liking.

COMMISSIONER GIBSON: You paint a rather extreme picture here; you say that in these circumstances theoretically the government may issue some long term debt, but it is faced almost constantly with the problem of maturities, and in these circumstances what does it do, does it put out debt that keeps the maturity structure above neutral, or does it tend to just put out short term debt? If it does this, you are having to offset the influence, isn't that correct?

MR. RASMINSKY: To offset? How do you mean?

COMMISSIONER GIBSON: The point is that if short term debt is put out in the latter stages of a period of expansion, you are tending to keep the economy liquid or making it more liquid rather than to try and keep the same maturity structure you have all along.

MR. RASMINSKY: I am sorry, I thought I had just dealt with that point. It would be my judgment that even without the assistance of government in putting out long term debt in the later stages of the boom that it would be within the power of the central bank to influence credit conditions as necessary.

COMMISSIONER GIBSON: I understand that. You said assistance of government, but if government wasn't keeping roughly the same maturity structure it would be working in the opposite direction.

MR. RASMINSKY: Well, the maturing debt, by the time it was maturing would be short debt, it would be very liquid.

COMMISSIONER GIBSON: Let us take another set

of circumstances; a period when there is a lot of liquidity in the economy, when you are just beginning to recover from a recession and the central bank is deliberately making the economy as liquid as it can from the cash point of view and you are hoping that this will take; this is a time -- and business is beginning to pick up -- this is a time when in terms of debt management you might think of going out longer because interest rates are favourable and the market is fairly receptive, yet in the interests of stabilization you may want to keep your refunding operations as short as possible and keep away from conversion operations so as to keep this liquidity working to stimulate business; isn't there -- let us not say a direct conflict but a difference in approach here?

MR. RASMINSKY: There certainly is a difference of approach and this perhaps is a good reason why there should be two independent authorities that decide on what shall be done, if I can understand the generalized statement that you are making, Mr. Gibson.

COMMISSIONER GIBSON: I was giving more or less an opposite situation.

MR. RASMINSKY: Yes, I know; I mean, if what you are saying comes down to this, that it is not inevitable that the debt management decisions of government shall be contracyclical in character, whereas it is inevitable that the monetary policy decisions of the central bank shall be contracyclical in character. That is the generalized statement that you are making,

I think that is correct -- the first is not inevitable.

COMMISSIONER GIBSON: I go a little further than that and I would say that central bank's interest in terms of stabilization is always contracyclical, but debt management may quite frequently be tending in a cyclical way; not always, but quite frequently.

MR. RASMINSKY: I don't see why it should quite frequently; I think that in general that the interests of the government in economic stabilization, in trying to maintain the appropriate credit conditions in the various phases of the cycle, are just as strong as the interests of the central bank and we don't have a monopoly on a desire to have stabilization effects on the economy, so I don't see at all that there is any inherent conflict between the type of decision that government will take with regard to debt management and the type of decision that the central bank will take with regard to monetary policy.

COMMISSIONER GIBSON: I am not sure there is an inherent conflict in the sense of the long range effects and results; indeed, one could argue if debt management were guided largely by stabilization considerations that the cost of the debt in the long run might not be any higher than if they just tried financial conversion when it seemed to be cheapest, because the investor would be getting a better deal by using stabilization procedures and might have a higher regard for government securities, but in theshort run surely there is a divergence.

MR. RASMINSKY: I don't agree with that last

statement that in the short run there is surely a divergence. If what you mean is that there is a possibility that debt management policy will be bad, then I agree, there is such a possibility. I would also agree that there is a possibility that monetary policy will be bad, but I don't see any inevitability of it.

COMMISSIONER GIBSON: Let us turn the question this way, do you think that debt management policy should be guided to a very large extent by stabilization considerations?

MR. RASMINSKY: I think that stabilization considerations and a contribution to appropriate credit conditions are important things that the government should have in mind in pursuing its debt management policies.

COMMISSIONER GIBSON: But not necessarily a prime consideration?

MR. RASMINSKY: I find difficulty in putting a number on it; I think it certainly is a very important consideration.

COMMISSIONER GIBSON: Do you think debt management would work out in a less satisfactory way from the standpoint of the national interest if it was largely guided by stabilization considerations than if it was not?

MR. RASMINSKY: Than if guided by what?

COMMISSIONER GIBSON: Well, if guided by a different set of circumstances? You say there are others and we admit there are others. In other words, do you think it would be a good policy from the stand-

point of the country if it were largely guided by stabilization considerations?

MR. RASMINSKY: I think that stabilization considerations should be given a good deal of weight in the debt management policies of government. There are other considerations that should be given weight, too; the needs of various classes of investors for securities of the different types, and I think that government has some responsibility to put out issues that meet the requirements of various classes of investors; the desire on the part of the public authorities to have a broad capital market with issues widely distributed among various types of investors and individuals, and the cost of various types of borrowing by government; these are all considerations that governments -- and no doubt there are others as well -- that governments would have to take into account. I would not want to range them in order of priority, but I would attach a great deal of importance to the one that we started talking about, the contribution that public debt management can make to the maintenance of appropriate credit conditions.

COMMISSIONER GIBSON: In thinking about the interest rate structure -- and this must be a prime consideration in debt management -- is it best to think -- I take it from your comments in speaking of monetary policy that you do tend to think or concentrate your thinking in the short end to a greater degree than on the long end of the market, the government securities market?

MR. RASMINSKY: Concentrate our operations, yes.

COMMISSIONER GIBSON: And your emphasis is to quite a large degree on cash management?

MR. RASMINSKY: We think about the whole range of the market, but we tend to concentrate on operations at the short end.

COMMISSIONER GIBSON: Are there times when, though, you do concentrate on the short end when you feel you should take a view about the whole structure? In other words, you gave an example yesterday in talking about the current thinking in the United States; prior to that we had an operation called "operation nudge" in the United States where there was an effort to change the structure so as to produce a particular objective of national policy. Do you think this kind of thing is appropriate to monetary policy?

MR. RASMINSKY: What kind of thing, Mr. Gibson?

COMMISSIONER GIBSON: Taking a specific view about the structure of interest rates and trying to do something about it at times.

MR. RASMINSKY: About the shape of the interest rate curve ?

COMMISSIONER GIBSON: Right.

MR. RASMINSKY: I think that,even though the monetary policy operates in the short end of the market,that it is not inconsistent with that for the monetary authority to have a view,not exactly precisely formulated as to what the precise shape of the interest

rate curve should be, but a view that the relationship of rates may be inappropriate from the point of view of credit conditions, that certain rates may be out of line, and to intervene occasionally to help to bring these into line.

COMMISSIONER GIBSON: Well, if interest rates are as important as you said yesterday they were as part of the cutting edge of monetary policy, are there not times when medium and long term interest rates may be just as important or even more important than short interest rates in achieving objectives of economic stabilization.

MR. RASMINSKY: Yes indeed, Mr. Gibson, and we deal with that at some length in our submission.

COMMISSIONER GIBSON: What I am getting at is this ---

MR. RASMINSKY: If I may just at this point for the record indicate that in paragraph 25 of our submission, on the techniques of monetary policy, we said:

"The Bank of Canada, however, cannot rely in all circumstances solely on the indirect influence that it can exert on interest rates through cash reserves. In certain situations as has been mentioned earlier, the central bank may feel that it should engage in limited market transactions in medium and long-term as well as short-term securities. From time to time it may be desirable to combat disorderly market conditions as, for example, when the market needs assistance in adjusting

itself to unexpected shocks such as the substantial shifts of assets sometimes associated with large-scale private or public operations. The sensitivity of international flows of funds to changes in interest rates may on occasion provide another reason for the central bank to operate in a particular area of the market. Changes in long-term as well as short-term yield differentials between Canada and the United States can induce substantial flows of funds from one country to the other and thereby aggrevate or ease exchange and other problems."

There is more to the paragraph, but perhaps that is enough to read.

COMMISSIONER GIBSON: Well, that doesn't go to the point I had in mind here.

MR. RASMINSKY: We had, I may say, a fairly recent experience, apart from the type of experience I referred to before, in the month of October which illustrates this; during the Cuban tension when the market here became very nervous, and in order to prevent a disposition on the part of investment dealers holding securities to liquidate them rather rapidly, which would have produced a disorderly situation in the market and a type of credit condition which, in our judgment, was inappropriate to the circumstances, the central bank in a period of two or three days bought over $100 million of government securities, which we were able later to sell back.

COMMISSIONER GIBSON: That is a very good example of your idea of what disorderly markets mean. Could you say any more about this subject?

MR. RASMINSKY: I have probably said too much already!

COMMISSIONER GIBSON: No, you have not.

MR. RASMINSKY: Well, I could say that $100 million is a lot of securities.

COMMISSIONER GIBSON: You look at a yield curve. Is this part of your consideration in deciding whether or not the market is orderly or disorderly? What about big gyrations?

MR. RASMINSKY: Big gyrations -- in a way. At that time we were too busy buying the securities to look at a yield curve.

COMMISSIONER GIBSON: I was not referring to the Cuba situation; that is a very clear example.

MR. RASMINSKY: Let us say that one has in mind that the existing pattern of yields is broadly appropriate to the circumstances and then some shock to the economic system may develop which seems to be temporary in character and to which the whole economy should not, in the judgment of the central bank, be required to adjust itself. This shock produces a lot of selling, or it could be a lot of buying of securities, with wide gaps between bid and offered prices on the securities. Perhaps there are very large, rapid changes without much in the way of actual changing hands of securities

-- a marking down of prices, a sort of vacuum in the market. In that sort of situation I think that the central bank would and should feel some responsibility for helping to prevent this situation from becoming a disorderly one. There are some risks involved in this. One of the risks involved is encouraging the market to be too dependent on the central bank, to look too frequently to the central bank, so that the market becomes less self-reliant and assumes less itself the process of making markets.

COMMISSIONER GIBSON: You do not want "disorderly" to become synonymous with "declining markets"?

MR. RASMINSKY: We would not want an effort to prevent or deal with disorderly markets on occasion to be synonymous with a situation where the Bank of Canada was making markets all the time. That is the point I was trying to make.

COMMISSIONER GIBSON: Going back to paragraph 25 of Section III. This is not really what I was getting at. You do deal with the times the Bank of Canada should have an interest in the whole structure, and you give a number of examples here which are rather specific examples and which are in some degree related to the orderliness of the market, though not entirely. I was going a little further than that and was asking you if you thought there were times when the Bank should take a pretty definite view, say, about the long rate as

opposed to the short rate. In other words, in a condition of very active demand and large investment boom, might it be appropriate for the central bank to concentrate its operations in the long end of the market?

MR. RASMINSKY: The straight answer to your question would be, yes, that possibility might arise. In the normal course of events, in that particular situation that you have mentioned, I think that I would expect that the cash management at the short end of the market could produce a sufficiently stringent cash position to achieve that result indirectly through the chartered banking system. So that I would not regard it as probable that in the course of a normal expansion we would want to operate extensively in the long end of the market, although I would not want to exclude that or any other possibility. The type of situation that I would have in mind is, again, I think, best illustrated by the situation this summer, where we were concerned with the spread in interest rates between Canada and other countries, and felt it necessary to take quite immediate action in that regard. In that situation, quite apart from what we did which had direct effects on the banking system and resulted in bank liquidation of securities, the Bank of Canada was in the market on a fairly extensive scale as a seller of long-term securities. That is the type of situation that seems to me to be more likely to require a departure from the normal attitude that

we have of wanting to concentrate in the short end of the market than the normal boom situation you have referred to.

COMMISSIONER GIBSON: So that in a boom, by tightening on the cash position through the short end you would expect to get an appropriate result at the long end of the market, and unless it appeared seriously inappropriate you would not intervene?

MR. RASMINSKY: That is right. The structure of yields thrown up by the market and cash management is usually a suitable structure of yields, and unless we have some important reasons for doing so, we would not try to influence it directly by our own operations as a purchaser or as a seller of securities, as distinct from the indirect influence that we have through our cash management operations.

COMMISSIONER GIBSON: I have one other question in this general area about cash management. Do any of the other Commissioners want to pursue this general subject of debt management further? If not, I would just like to ask you for your view on the proposal which has been put to us in several variants that cash management -- that is, management of government cash -- might be used more deliberately and to a greater degree as an instrument supporting stabilization of policy. The idea is that instead of debt repayment and purchase of government securities at a time of active business, the government might build

up its bank balances and just keep them idle, if you like, keep them out of the active spending stream. This has been put to us as a better anti-inflationary device than debt repayment or security purchase, in that the funds that are being repaid do not go back into the spending stream. What do you think of this technique? Do you see it as having any advantages that cannot be achieved through monetary policy methods?

MR. RASMINSKY: No, I do not. Essentially, I think this idea, as I understand it, is that the government would run a surplus of receipts over expenditures during the boom phase of the business cycle, and instead of repaying debt would hold the money on deposit with the banking system, and then it would run a deficit during the recessionary phase of the cycle, and instead of borrowing to meet the deficit it would draw down its cash balances.

There are some problems involved here. The government always has maturities coming along on short term debt. The government has to pay those maturities, so the government would be called upon, or be expected, though it had large cash balances in hand, to go to the market during this upward phase of the cycle, when presumably interest rates were on the high side -- the government would be expected to go to the market and borrow to repay maturities, instead of using its cash balance.

COMMISSIONER GIBSON: Surely, that would not be a problem if the appropriate rate of

interest were negotiated for this type of operation?

MR. RASMINSKY: I do not think that necessarily need be an overwhelming problem, but I do not think when the dust is cleared away that the monetary effects of this procedure which has been suggested, or the effects on credit conditions, are essentially different from the effects which would be obtained through the incurring and repayment of debts in the usual way. So I do not really see that this system, which has some of these practical difficulties that I have mentioned, has any inherent advantage over what one regards as a normal system.

COMMISSIONER GIBSON: There is this one difference in the way it would work. If debt is repaid people get these balances and have their further use. If the debt is put into idle bank balances it is not further available, and the central banks, therefore, in the first place, would pursue a little tighter cash management policy than it would in the second instance, where the debt was immobilized. In one case you would be tightening up monetary policy a little more, and in the other case you would be immobilizing these balances.

MR. RASMINSKY: I am not sure how that would work. The effect of this policy would be that during the boom phase of the economy there would be a very considerable shift of deposits from private accounts to the account of government. The banks would be more liquid than they would be if the alternative policy were followed.

COMMISSIONER GIBSON: Why would that change their assets?

MR. RASMINSKY: Under the alternative policy the government would be running a surplus during the boom phase --the situation that we have considered --and the government would be redeeming securities with the surplus. The total assets of the banking system would be reduced because some of the securities paid off would be securities held by the banking system. I think the banking system would be smaller.

THE CHAIRMAN: We shall adjourn for fifteen minutes.

--- Short recess.

THE CHAIRMAN: We shall now resume.

COMMISSIONER BROWN: Mr. Chairman, I would like to address a few questions to Mr. Rasminsky, rather coming down from the generally high level of principles to operating problems.

In paragraph 22 -- you do not need to refer to it -- you outline, in general, the method of appointing primary distributors, and I just wanted to ask you, for the record, whether it is fair to say this is not a closed list at any time, and that any security dealer who is willing and demonstrates a desire and ability to distribute bonds can get on the list.

MR. RASMINSKY: It certainly is not a closed list, Mr. Brown.

COMMISSIONER BROWN: In another paragraph you refer to problems of firm allotment.

MR. RASMINSKY: Yes, sir.

COMMISSIONER BROWN: And are readjustments in allocations a continuous process in this?

MR. RASMINSKY: Yes, they are, Mr. Brown. The firm allotments are looked at in respect of each new issue. They are, in principle, based on the ability of the primary distributors on the list to distribute bonds as indicated by the past record and the character of the distribution. After each new issue we receive a statistical report, as you know, from investment dealers covering the character and the extent of their distribution of the new issue to investors for a certain period which, I believe, may be four or six weeks after each issue. This is the primary information that we look at in determining what the allotment shall be. We keep a name file on each primary distributor in which additional information is added regarding his participation in other issues -- that is, issues other than government of Canada -- and his distribution of Canada Savings Bonds, his participation in the Canada Savings Bond Payroll Organization. In some cases we have financial statements relating to the individual distributor; and all this information is kept on record and is taken into account in an attempt to make an equitable distribution of the firm allotment

of bonds, in accordance with the market performance, in accordance with the relative size, placing power and general status of the particular firm in the industry.

COMMISSIONER BROWN: I suppose a problem sometimes arises if either you make a mistake or some external situation arises just at the time of an issue, that means an issue has been over-priced and a dealer who happens to assess correctly this situation and stays out of the market in his own interest and in the interest of his clients. Do you take this possibility into consideration?

MR. RASMINSKY: We would not eliminate a dealer or drastically cut down as a result of one situation -- You are thinking of a situation that would affect a particular issue?

COMMISSIONER BROWN: Yes.

MR. RASMINSKY: Yes, that would be taken into account. Also, of course, there would be taken into account -- this is another factor that creates a difficulty in determining what the firm allotment of particular firms shall be -- that the placing power of any particular firm may vary according to the term of the issue. One investment dealer may have developed a clientele which is particularly interested in issues of a certain maturity, and this might be another reason, in addition to the one that you have mentioned, why a dealer does not have as much interest in an issue that does not meet those requirements. We try

to take all these factors into account to the greatest extent that we can.

COMMISSIONER BROWN: You mentioned the matter of character of distribution.

MR. RASMINSKY: Yes.

COMMISSIONER BROWN: Do you make a habit of telling dealers what you regard as the ideal character of distribution?

MR. RASMINSKY: No, we do not, Mr. Brown, but it is obviously of interest to the central bank to know whether the particular dealers are selling their bonds to a major extent to other dealers or to the investing public, to institutions, the individual public, or to banks. This is all information that from time to time, depending on the nature of the issue and the type of distribution which is desired, would be relevant.

COMMISSIONER BROWN: Are any dealers ever advised that it is not your wish that a particular issue go to certain types of institutions?

MR. RASMINSKY: No, not to my knowledge. Basically we would rely on the characteristics of the issue itself to affect the distribution. If a particular issue has been approved by government with characteristics, for example, which are intended to make it attractive to corporate investors, then in the normal day-to-day contacts which we have in the market we would naturally show a particular interest in what is happening to the sales by investment dealers to corporate investors as distinct, for example, from their sales to chartered banks.

In the circumstances I have mentioned, such conversations could take place between officials of the Bank and investment dealers with a view to ascertaining what the character of the distribution of the issue was.

COMMISSIONER BROWN: There is a distinction there between ascertaining and influencing.

MR. RASMINSKY: There is a distinction, Mr. Brown, and it may well be the case that in the situation I have described the net result of the conversations we have, and the questions asked to provide us with information, could give the dealers an indication that the issue had been tailored for corporate demand, and that therefore the central bank would be better satisfied with distribution of that character.

That could be the result, but it falls short of any request to dealers to push the securities in one direction or the other.

COMMISSIONER BROWN: Can we go to the other side of the picture and ask you if it is ever indicated to certain buyers that it would be preferable if they did not participate in an issue?

MR. RASMINSKY: Not within my experience, Mr. Brown, no.

COMMISSIONER BROWN: I know that you have been experimenting with this present system of offering somewhere in the neighbourhood of 60 per cent of an issue on a firm basis and providing for

subscription up to double the firm bonds accepted. Has this been proving a satisfactory method of operation?

MR. RASMINSKY: In the issues where that has been done we think that it has worked quite well.

COMMISSIONER BROWN: In the past auctions were used once or twice. Have you any comment on how these worked?

MR. RASMINSKY: I am afraid there is really nothing I can say that would be helpful about that, Mr. Brown. There have been no bond auctions during the time that I would have been concerned with them. In general I would say that the debt management authority should have an open mind to all techniques for distributing bonds and, as you know better than I do, this technique for the distribution of a long-term issue was recently used, just within the last week, in the United States, and apparently quite successfully.

COMMISSIONER BROWN: In connection with new issues there have been suggestions from various groups, including the Investment Dealers' Association, that a committee be formed from participants in the market to advise on these matters. I would just like to invite your comments on this suggestion.

MR. RASMINSKY: An advisory committee to government?

COMMISSIONER BROWN: Yes.

MR. RASMINSKY: It would, of course, be a matter for government to decide what channels it

wished to use or establish to get advice on these matters. I do not think I could make any further comment than that.

COMMISSIONER BROWN: In recent years there has been a partial advanced refunding technique used which, to a degree, has constituted a tap issue. Would you like to comment on how successfully this has operated?

MR. RASMINSKY: Yes. We dealt with this at some length in our submission; paragraph 16, page 48. It is my view that this advanced refunding technique, which I think I am right in saying was invented here, has been a useful instrument in the management of the public debt. It enables maturities to be cut down in size and reduced to more manageable proportions.

This is accomplished, as you know, by the process wherein the central bank, through its operations, lays its hands on the nearby maturities and exchanges them for other maturities which in most cases, and indeed I think in all cases, have been mid-term maturities, and this puts the central bank in possession of a new market issue which it can feed out to the market in response to market demands for the issue.

I think that the analogy you make with a tap issue is not an inappropriate analogy and in feeding them out it can lay its hands on additional amounts of nearby maturities if it does this feeding out on a switch basis.

The considerations involved as regards the use of this technique include, of course, a very important consideration, which is the size of the maturing obligation, and the extent to which it is desired to cut it down. The main use of it, as you know, was in connection with the maturity of the first conversion loan of 1961. Another consideration is the willingness of investors, the general public, to lengthen their holdings of government securities, and the prices that would be required to induce them to do so through the exchange of the nearby maturity for the new issue into which it is refunded. The general answer to your question is that this technique, in my judgment, has operated well, and it is a useful one.

COMMISSIONER BROWN: And it also gives you an opportunity to test gaps in the market in the maturities range.

MR. RASMINSKY: That is right. It adds to our armoury of securities of varying maturities.

COMMISSIONER BROWN: You have several paragraphs in which you mention some of the problems which arise in connection with new issues, such as the matter of over-trading, and you comment that this over-trading "often contributes to disorderly markets and hampers distribution to investors."

At first glance it would appear that this in fact helps to get an issue distributed as an alternative method to removing price restrictions sooner.

MR. RASMINSKY: I am very interested in the fact that you believe over-trading is a useful technique for the distribution of issues.

COMMISSIONER BROWN: I was not considering it as a useful technique for the distribution of issues, but I am just wondering why you say it hampers distribution to investors?

MR. RASMINSKY: The judgment of those concerned has been that the uncertainty created by this practice, which of course is not confined to government issues, is likely to contribute to, shall I say, unsettlement and lack of certainty in the market and act as a factor which keeps distribution from going forward normally into the hands of ultimate investors.

COMMISSIONER BROWN: Is the alternative to remove restrictions sooner?

MR.RASMINSKY: I suppose that if one were certain the issue had been wrongly priced, and that what one was concerned with was something more than a temporary speculative interest, then the alternative of an earlier removal of price restrictions and an earlier adjustment to market levels might be desirable. Of course, the extent to which over-trading takes place must depend in part, I suppose, upon the commission which is paid to the dealer. It is this commission which enables him to over-trade without being actually out of pocket.

COMMISSIONER BROWN: In your price restrictions, the restriction in fact is that these bonds not be sold below the issue price. One some-

times hears criticism that it should also be restricted on the upward side; in other words, on the first distribution they should not be sold above the issue price.

This comes from would-be investors who say that the distributors are protected but the public is not. Has this been considered? I realize that this would be just as difficult to police as the problem of over-trading.

MR. RASMINSKY: It has not come up for consideration during the period that I have been concerned with these things, Mr. Brown. It is usually the case that dealers will sell at the offering price to their clients. Dealers, like other people, are not in business for a day, and they can normally count on other issues coming along. I really should not say that I think this, for I have really no experienced judgment in the thing, but it seems to me probable that this would act as a sufficient restriction on dealers and that the price restriction on the other side is not necessary.

COMMISSIONER BROWN: You do mention the problem of "riders". I think everybody in the investment industry would be delighted if you could give us a possible solution to this problem. Have you any ideas?

MR. RASMINSKY: No. I think this is something the industry will have to solve for itself.

COMMISSIONER BROWN: I have a couple of questions on treasury bills. Suggestions have been made, and we would be very grateful if you would give us your opinion on a couple of them. One is that the chartered banks should stay out of the tender on their own account, as it is done, I think, in the United Kingdom. Another is that the Bank of Canada should be neutral on amount, as in the United States. A third suggestion has been made that the Bank of Canada should be neutral on amount and price, certainly on price in the sense of not saying they are going to take X million dollars of the issue on the average bid price by the public.

Would you care to comment on those suggestions?

MR. RASMINSKY: I don't know that I can make any very helpful comment on them. The first two I take are designed to produce a situation where the entire treasury bill issue is auctioned to investment dealers and where the chartered banks and the Bank of Canada are required to obtain the treasury bills that they want through dealers.

COMMISSIONER BROWN: I think you misunderstood the second suggestion. That applies to the first. The second one is that the Bank of Canada should be neutral on amount; in other words, bid to replace their maturing bills.

MR. RASMINSKY: Yes, but there are occasions when from the standpoint of monetary policy the Bank of

Canada wishes to add to its treasury bill holdings, and I presume that it would be a part of this proporal that on such occasions the Bank of Canada should have to obtain from investment dealers the additional amounts that it wanted after rolling over.

COMMISSIONER BROWN: Or buy them before rolling over.

MR. RASMINSKY: Or buy them before.

I don't see any particular merit in either of these suggestions. The chartered banks are substantial holders of treasury bills, and I would see no reason for changing, or suggesting a change to the Minister of Finance in the treasury bill arrangements which would make it improper or impossible for the chartered banks to bid directly for treasury bills; nor do I see why the Bank of Canada, in the ordinary process of cash management or in the process of attempting to influence credit conditions, should have this particular technique ruled out of bounds.

COMMISSIONER BROWN: On the matter of different kinds of bond issues, you referred to the fact that the government makes a decision about such things as convertibility, call price and so forth. There have not been any recent issues of callable bonds by the Government of Canada, and I wondered if in their consideration the Bank does perhaps figure on the relative costs for the issuing of callable bonds and non-callable bonds.

MR. RASMINSKY: You mean the historical costs?

COMMISSIONER BROWN: No. I mean their estimate of what it would cost in a differential yield, and in having callable bonds offset by the potential advantages in being able to redeem within a certain limited choice of time, as against a straight non-callable bond where you don't have this choice of timing at the maturity end.

MR. RASMINSKY: I think I would have to answer that question quite generally, Mr. Brown, by saying that the Bank in deciding what advice it shall give to the Minister takes into consideration all aspects that it can of the securities market and of the terms of the new issue.

I don't wish you to infer from that, that with respect to every new issue the Bank, in deciding what advice to give to the Minister, makes a precise or attempts to make a precise estimate - and it can be nothing more than that - of the difference in cost that would result from the insertion of a call feature.

COMMISSIONER BROWN: The fact that they have not used it, and it was used so considerably outside, is this because in your estimate the yield cost would be considerable?

MR. RASMINSKY: I suppose, Mr. Brown, the basic reason why a call feature has not been used recently is that a quite high proportion of debt has been issued on relatively short maturity, where a call feature has not been appropriate.

The problem has been rather of the opposite character, illustrated by the inclusion of a conversion

privilege to extend a relatively short maturity into a long maturity, like the $5\frac{1}{2}$'s of 63 extended into the 76's. The absence of a call feature in many of those outstanding issues does not, of course, act as an inhibition against the redemption of government debt. The government has quite a steady flow of maturities.

COMMISSIONER BROWN: I was thinking particularly of the $5\frac{1}{2}$'s maturing in 1980 which were issued in the summer -- you wouldn't call that a short term issue?

MR. RASMINSKY: No, I wouldn't call that a short term issue.

COMMISSIONER BROWN: But it had no call feature?

MR. RASMINSKY: It had no call feature. That issue, you may recall, had a purchase fund, so that the entire issue will not be outstanding until 1980.

COMMISSIONER BROWN: This is perhaps almost a theoretical question: is one of the problems of monetary policy that is considered - and perhaps this is the way I should phrase the question - as to whether the callable bond when it reaches the date of callability does provide problems for monetary policy?

MR. RASMINSKY: I would say not, Mr. Brown. The callability of a bond is an option that the government can exercise, and I would assume that there would be sufficient coordination and community of view between the central bank and the government with regard to the advisability of exercising the call privilege.

The central bank has no preconceived ideas against the insertion of call features in appropriate cases.

COMMISSIONER BROWN: Did the existence of short term convertible bonds in fact prove at all embarrassing for monetary policy?

MR. RASMINSKY: I think it proved more embarrassing to speculators than it did to the monetary policy. One has to regard these issues as having been successful debt management operations. You have probably seen in the case of the $5\frac{1}{2}$'s of 63 that of the amount of approximately $445 million outstanding, all except $12 million or $14 million was converted.

COMMISSIONER BROWN: On the other hand, I suppose the fact of this conversion meant that during the period leading up to the expiration of the conversion privilege, the fact that this issue was about to become a long term issue would have to come into all your considerations of debt management.

MR. RASMINSKY: Yes, indeed.

COMMISSIONER BROWN: A suggestion was made, I think by the Investment Dealers Association, that a standard sinking fund be established for government issues of one per cent. This would presumably apply to issues beyond a certain maturity. Would you care to comment on that?

MR. RASMINSKY: The decision whether to establish a sinking fund would be a matter for government policy, on which I don't think it would be appropriate for me to comment, Mr. Brown. I would remind you again that the $5\frac{1}{2}$'s of 1980 include provision

for a special purchase fund.

I should add, on the suggestion relating to the sinking fund, a reminder of the existence of the Purchase Fund which provides a mechanism for the purchase and cancellation in advance of maturity of outstanding issues having maturity of ten years or more.

COMMISSIONER BROWN: It has been represented to us that it would be overall cheaper in interest costs if the C.N.R. borrowed from the government and the government borrowed from the public. Do you see anything wrong with this approach?

MR. RASMINSKY: There again, Mr. Brown, this is a matter of government policy affecting not only the issues of government securities but also the financial relations between the government and the C.N.R., and I think I must ask to be excused from commenting on that question.

COMMISSIONER BROWN: Perhaps I could rephrase it slightly and ask you if you would agree that the interest costs would be a little cheaper?

MR. RASMINSKY: The yields on C.N.R. securities guaranteed by the government are higher than the yields on straight government securities. So, I think it would be fair to say that it would be cheaper for the government to borrow directly and lend to the C.N.R.

COMMISSIONER BROWN: On the matter of Canada Savings Bonds, has the Bank any figures that would be available on the real cost of issues that come along that provide opportunities for conversion of previous issues?

In other words, have you an estimate of the real cost of the new money that is produced - to use hypothetical figures - that to get a half billion dollars of new money, a billion worth of Canada Savings Bonds have to be issued, and therefore, you have to pay commission twice and you have increased interest costs.

MR. RASMINSKY: It is my understanding, Mr. Brown, that the question of costs in connection with Canada Savings Bonds issues was raised with the Deputy Minister of Finance, and that the Department of Finance undertook to provide the Commission with some information on the subject.

COMMISSIONER BROWN: Have the parity bonds that have been issued by provinces provided any problems for monetary policy operations?

MR. RASMINSKY: Not to my knowledge.

COMMISSIONER BROWN: In connection with the market operations by the Bank of Canada, we have heard it alleged that because the Bank has its decision-making authority in Ottawa away from the, shall we call them, financial centres of Montreal and Toronto, that the Bank's information on market developments isn't always as complete or current or correct as it might be. I think you should have an opportunity of answering this criticism.

MR. RASMINSKY: The criticism would be easier to answer, of course, if it were more specific in its terms.

I suppose that anybody's information about anything is likely to be not as complete as it might be under some circumstances. If the question is whether I feel that we have reasonably good information as to what goes on in securities markets, notwithstanding the fact that the head office of the Bank is in Ottawa, away from the financial centres, the answer is that I do think that we have good information.

We have traders in Toronto and in Montreal who are in direct contact with the securities markets, with investment dealers and others, and we in Ottawa -- those concerned in Ottawa -- are in very frequent communication by telephone with the markets. We have direct tied lines to both centres, so no one has to worry about paying a long distance bill when he picks up the phone, and these are used very frequently. People from our Securities Depart-

ment move around a good deal, in fact, to Toronto and to Montreal, and the Department is engaged in a regular series of visits to investment dealers.

It is my impression -- and I am very pleased that you have given me the opportunity of making this statement -- it is my impression, Mr. Brown, that notwithstanding the fact that the head office of the Bank of Canada is located in Ottawa, that the central bank is in more direct contact and has more information from day to day as to what is going on in the securities markets than the central banks of most other countries, including those with which you would most naturally compare us.

COMMISSIONER GIBSON: May I interject? Including the United States, Mr. Rasminsky?

MR. RASMINSKY: Yes.

THE CHAIRMAN: Is it fair to say that the Bank of Canada is the main channel of communication between the government and the market?

MR. RASMINSKY: I am afraid I am not able to answer that question, Mr. Chairman, because I have detailed information on what our own communications with the market are and I don't have detailed knowledge as to what the communications of the government are. It is certainly my impression that the Bank is closer to the market and sees more from day to day of what is going on in the market than government does.

THE CHAIRMAN: Or than any department of the government or any ---

MR. RASMINSKY: Yes, I meant what I said to be ---

THE CHAIRMAN: I suppose you couldn't say whether there were any outside infrequent contacts of one with another, but as to a regular channel of communication between the market and the government, the Bank of Canada would be the chief channel?

MR. RASMINSKY: Yes. I hesitate over your use of the term "channel of communication".

THE CHAIRMAN: That may be.

MR. RASMINSKY: If the market wished to communicate anything to the government, they would communicate it directly to the government, but if the question is whether we are closer to the market than government, it is my impression -- without really having all the facts at my disposal -- that the answer to the question is affirmative as, indeed, I think would be the normal situation in most central banks. I think that most central banks would have closer contacts with the financial community.

THE CHAIRMAN: Well, you are operating in the market.

MR. RASMINSKY: That is right.

THE CHAIRMAN: And you are in daily contact with the market one way or another, almost.

MR. RASMINSKY: That is right.

THE CHAIRMAN: And you are fiscal agents for the government, and as such would have dealings with the market?

MR. RASMINSKY: Oh yes indeed; in the course of our ordinary open-market operations we are in momentary contact with the market.

COMMISSIONER GIBSON: Would you care to elaborate a little on why you think that the Bank of Canada's contact with the market compares favourably with that in the United States, the Federal Reserve System? They go to very special efforts, and that is the reason I mention this question.

MR. RASMINSKY: Well, I don't understand the relevance of the last comment, Mr. Gibson. We, too, go to very special efforts.

COMMISSIONER GIBSON: I know you do, but rather differently, isn't that correct?

MR. RASMINSKY: I think that our range of contacts -- for one thing, we operate over a wider range of government securities than the Federal Reserve System does under the bills only doctrine.

The statement that I made, which was an interjection, and one that I wouldn't attach great importance to, is based upon the general impression that I have as to the way other central banks operate. I know in the case of the Bank of England that the Bank in England operates entirely through its so-called government broker; it doesn't have operational contacts with the market at all.

COMMISSIONER GIBSON: No, not in a narrow sense.

THE CHAIRMAN: Mr. Rasminsky, we have

arranged that we shall break off before twelve o'clock. Would 2.15 be satisfactory to you to resume?

MR. RASMINSKY: Yes.

THE CHAIRMAN: We will now adjourn until 2.15.

--- Luncheon Adjournment.

--- Upon resuming at 2.15 p.m.

THE CHAIRMAN: We will now resume. Mr. Brown?

COMMISSIONER BROWN: Mr. Chairman, I wonder if Mr. Rasminsky would care to tell us to the degree he feels he can without prejudicing the position of the Bank -- we don't want to put you in that position or want you to put the Bank in that position -- the degree of authority that is given to the traders in Toronto and Montreal.

MR. RASMINSKY: When the Bank has decided on a program to respond to the developments in the securities market, this program is communicated to the traders in Toronto and in Montreal.

They are told, for example, that they have authority to buy or sell specified securities at certain prices up to limits that are decided in Ottawa. We are, through the traders and from our other sources of information, continuously informed as to developments in the market and decisions are reached in Ottawa as to how to respond to such developments, and these are in turn communicated to the traders in Toronto and Montreal so that these limits on the extent to which the Bank will respond -- the bids or offers in the market vary, of course, from time to time depending upon what we are trying to accomplish through our action -- at all times within these limits the traders in Toronto and Montreal can deal for the account of the Bank without the need

to refer to Ottawa.

Of course, it does happen in rapidly changing markets that the decisions that are taken as to the degree of our intervention in the market are necessarily tentative; they may be altered quite frequently. By actual count, Mr. Brown, the average time in the cases where the reference to Ottawa is needed, where the trader in Toronto and Montreal is not able to deal immediately, the actual time taken for a decision to be reached in Ottawa and to put him in a position to respond is actually not very long; it is something in the nature of 20 minutes, although there are occasions if there have been very large movements in the markets or if the Bank is contemplating reaching the point of making a rather more major change in its posture in the market, such as getting out of trading in a particular issue altogether, there are occasions when the delays could be longer than that.

COMMISSIONER BROWN: We have had representations that the system of responding only to bids and offers results in the same information being given, in fact, as though they had given a picture of the market to anybody phoning up, but it has taken an awful lot more time to get that information out of the trader. Have these representations been made directly to the Bank?

MR. RASMINSKY: I am very sorry, I haven't followed the question.

COMMISSIONER BROWN: Well , on the basis of finding out from the trader by means of tentative

bids and offers, and the would-be trader on the other end of the line gets a picture of the market.

MR. RASMINSKY: Right.

COMMISSIONER BROWN: It takes a considerable amount of time to get this picture on the market?

MR. RASMINSKY: It may on occasion.

COMMISSIONER BROWN: And it is holding up other people who are also trying to get the same information, and it has been suggested to us that they end up with a picture, but why shouldn't they just be started with this picture and then get on with the job and let sombody else get the picture?

MR. RASMINSKY: Well, what would the alternative be, Mr. Brown?

COMMISSIONER BROWN: To indicate from the beginning the position from which you are prepared to act.

MR. RASMINSKY: That the Bank should have posted buying and selling prices for securities?

COMMISSIONER BROWN: I am not putting this up as an alternative.

MR. RASMINSKY: I would like to know what is the alternative on which you would wish me to comment. The situation that involves delay is one in which the Bank has not formed a definite decision as to the prices at which it is prepared to deal.

COMMISSIONER BROWN: You misunderstood me.

MR. RASMINSKY: I am sure I have.

COMMISSIONER BROWN: Some dealer is trying to determine what the market is on say, a $4\frac{1}{2}$ per cent issue due in 1983.

MR. RASMINSKY: Are they trying to determine what the market is or the price at which the Bank of Canada is prepared to deal?

COMMISSIONER BROWN: At the price at which you are prepared to deal?

MR. RASMINSKY: Yes.

COMMISSIONER BROWN: And so they start at one level and move, depending on whether they are offering or buying, move down or up.

MR. RASMINSKY: Yes.

COMMISSIONER BROWN: And then they approach near the point, I understand, at which time the trader might indicate to them that if they move a little further they probably will do the transaction. This all takes time to get this information because they have to start at, say, 93 and then 7/8's and then 3'4's, and move down or up depending on which direction they are going, and if they are going to end up with the information anyway, but only after going through a long rigamarole, this has taken a considerable amount of time and meanwhile the other people are trying to start on the same rigamarole to get the same information, and my question was have representations been made to you directly on this particular point?

MR. RASMINSKY: The answer to that question is no.

COMMISSIONER BROWN: In other words, there would be no criticism of the length of time it has taken to get this information?

MR. RASMINSKY: I am sorry, that is a

different question. The fact that you have raised this apparently indicates there has been criticism?

COMMISSIONER BROWN: Yes.

MR. RASMINSKY: The question to which I was responding was whether any representations have been made?

COMMISSIONER BROWN: Have been made to you.

MR. RASMINSKY: Have been made to me.

COMMISSIONER BROWN: I think it is a matter for the market to approach the Bank on directly.

MR. RASMINSKY: I wouldn't regard it as a function of the central bank to make the market. That is inconsistent with the general view that I have as to our role and the general view that runs throughout the submission that we have made to the Royal Commission; nor, indeed, would I regard it as the function of the central bank to give a picture, be prepared to give a snapshot picture at any moment of time as to what the prices of securities are.

I think that the market itself is the source, or should be regarded as the main source of information as to what the prevailing prices are at which securities can be moved in the market. The function of the Bank, as I see it, is to be prepared to deal at certain prices that the Bank from time to time determines in the light of its best judgment as to what the situation calls for. There are only two ways that I see by which the Bank can carry out that function. One is the way that we use now, which is to respond to bids and offers in the market; and the other would be to have posted prices at which we were prepared to deal in the market, at all times subject to change. These posted prices would provide the picture that you indicate is sought by some as to the Bank of Canada's view of the market; but that system of posted prices, in my judgment, gives the central bank too much responsibility and too dominant a role in the making of market prices.

COMMISSIONER BROWN: I agree with you that it is a very difficult position you have in following out the principle on which you choose to operate. The fact does seem to remain that the market seems to get a picture of what the Bank is prepared to do at any time, but they get this through a very long, slow process.

MR. RASMINSKY: The market gets an indication of the prices at which the Bank is prepared to deal with respect to individual transactions. All that the Bank commits itself to when it buys a

security at a given level of prices is the price that it will pay for the parcel of securities that is offered to it. There is no further commitment than that involved. So one might say that the market does not even get a picture of what the Bank is going to do in the next offering that may be made to it.

COMMISSIONER BROWN: That is understood. Have you an estimate of the bank's participation in the market as a whole? Or shall I put it the other way: Do you feel -- and if you do, to what extent do you feel -- that the market does tend to lean on the Bank?

MR. RASMINSKY: I do not think that that is a situation that remains the same throughout time, Mr. Brown. At times when the Bank, in pursuance of the type of intervention in the market that it prefers, is confining its activities mainly to the short end of the market the rest of the market acts in a more self-reliant way, without leaning heavily on the Bank. At the other extreme, at times when the Bank, for one reason or another, is pursuing certain definite objectives in regard to interest rates and is achieving those objectives through large-scale intervention in the market, the market does lean heavily on the Bank to know what market prices are.

This involves some difficulties. It involves difficulties of disengagement. There is more than one setting on the dial of the scale of

Bank intervention in the market. As the Bank is moving from a situation in which it has been intervening quite strongly in the market back to one in which -- and I am thinking now of intervening strongly in other than the short end of the market -- back to a situation where its market activity is confined to the short end, then one has a mixed situation in which the market may have encountered a little difficulty in getting back to its own market-making or price-making activities.

But as I say, there is more than one setting on the dial, and I think the setting that I would prefer is one in which the market does not lean too heavily on the central bank for guidance as to what the level of security prices should be in the market.

COMMISSIONER BROWN: In paragraph 59 of the section on debt management ---

THE CHAIRMAN: I have one question following on this, first.

Mr. Rasminsky, you mentioned that the trader was given authority to trade, or given a certain amount of latitude, to a high point and low point, in which area he was entitled to buy or sell, as the case may be. Can you give us some idea as to the magnitude of that latitude that he might be given? I understand it would be varying from time to time, but what would be the extreme upper limit and the more or less average? Is my question clear?

MR. RASMINSKY: Yes, your question is clear, Mr. Chairman; but it is a question with market implications, and I would prefer, if you would excuse me, not to answer the question.

THE CHAIRMAN: Very well.

COMMISSIONER BROWN: Paragraph 59 of the section on debt management. In it you say:

" In each securities transaction executed on behalf of Crown organizations or Government accounts the Bank of Canada states that the purchase or sale is for an account, and the subsequent contract shows that the Bank of Canada has acted as an agent rather than on its own behalf."

When the Investment Dealers' Association appeared before us there was a difference of opinion on this point, and subsequently we had a letter from the president of the Investment Dealers' Association which I think should be read into the record in order to correct certain impressions. Have you seen a copy?

MR. RASMINSKY: He was kind enough to send me a copy of the letter, and I am pleased you intend to read it into the record.

COMMISSIONER BROWN: It is addressed to the Secretary of the Royal Commission, and it says:

" During the hearings of the Investment Dealers' Association of Canada, by the Royal Commission on

" Banking and Finance on July 12th, 1962, Commissioner Mackintosh stated that it was his understanding that the Bank of Canada always makes clear in its transactions whether it is acting as agent or acting as principal on its own account.

Certain questions and answers followed and are recorded on pages 2891 to 2893 of the transcripts of the hearings. Some of our delegates made positive statements inferring that the Bank does not always make clear whether it is acting as agent or as principal.

At the request of the Governor of the Bank, we have held meetings of those actively engaged in trading with the Bank of Canada and find that these statements cannot be substantiated and that the confusion as to the role of the Bank in these transactions does not arise from failure on their part to give such advice.

It would be appreciated if you would take whatever steps are necessary to correct the impression created by our assertions."

That letter is under date September 12th, 1962.

Now, my question, Mr. Rasminsky, is this:

Other central bankers with whom we have discussed this particular point say it is not their practice to give this information, except if it suited their own purposes, at the time of the transaction. One of them went so far as to say that it was not any of the business of the street what they were really doing; that in order to carry out their functions they should try to keep the market from knowing just exactly what their long-term intentions were.

MR. RASMINSKY: Yes, I think Mr. Sproul said that.

COMMISSIONER BROWN: Yes, Mr. Sproul said that, and at least one other. Mr. Sproul went on to say, if I remember correctly, that he did not regard it as a good principle of central bank action to undertake certain commitments and act in accordance with certain rules if you did not have to. I am paraphrasing him a little. The logical question to ask is: Why does the Bank of Canada undertake to give this information?

MR. RASMINSKY: That is a very good question! This is a procedure which I inherited, the rationale of which I, in fact, have not thoroughly examined. I suppose that it must be based upon the thought that the attitudes of the investment community towards the actions of the central bank would differ according to whether these actions were being undertaken for reasons connected with monetary policy or as a result of a government transaction. In other words, whether the securities were being bought or sold for the account of the Bank

itself or for the account of a client.

I suppose the rationale must be that since this might affect the views of the investment community, they are entitled to this information.

COMMISSIONER BROWN: Obviously, they are seeking clear signals.

MR. RASMINSKY: Yes, they are seeking to know what the central bank is doing for its own account.

COMMISSIONER MACKINTOSH: Could not it be just simply that the investment dealers are required to reveal when they are acting as principal or as agent, and what is fair for one is fair for the other.?

COMMISSIONER BROWN: One other point on which we would like your views is this question of statistics on holdings of the Bank of Canada and government accounts. As I understand it, in the United States they publish a consolidated list by maturities of the combined holdings of the Federal Reserve System and the government accounts. These appear fairly quickly after the end of any period. It has not been the practice to make such detailed information available here, but it is available in general classifications, but not by maturities.

MR. RASMINSKY: By general classification I think that the information provided regarding the distribution of outstanding Government of Canada debt is a good deal more up-to-date in Canada than

it is in the United States or elsewhere. At the present time, for example, in the Bank of Canada release of weekly financial statistics dated January 10th, you can get a breakdown of the distribution of treasury bills, and other securities -- that is Government of Canada securities outstanding -- as between the Bank of Canada, chartered banks, government accounts and the general public -- which, as you know, includes investment dealers -- as of January 9th, 1963. That is a delay of approximately 24 hours.

The corresponding figures for the United States are published in the Treasury bulletin, and we received in the Bank today the Treasury bulletin dated December, 1962, which shows a similar distribution of the estimated ownership of federal securities, giving somewhat more detail regarding the amounts held by private non-bank investors than our figures do, as at the end of October, 1962, so that the figures provided here on the general distribution as to ownership of government securities, I would say, are considerably more up-to-date than they are in the United States.

COMMISSIONER BROWN: We all recognize that, Mr. Rasminsky. After all, we look at these figures ourselves each week.

MR. RASMINSKY: Yes.

COMMISSIONER BROWN: So we know that they are available, but I was asking about the more detailed breakdown which I do not think is pub-

lished at all in Canada, is it?

MR. RASMINSKY: Do you mean the more detailed breakdown as to who owns the securities?

COMMISSIONER BROWN: As to the securities by maturity owned by government and Bank of Canada account -- not by maturity, but the combined holdings. This is not available here, is it?

MR. RASMINSKY: The combined holdings are the ones that I have indicated, broken down by treasury bills and other securities. The additional detail beyong the distribution we give as between Bank of Canada, chartered banks, government accounts and the general public is given with a longer lag. The additional detail given by the United States indicates the holdings of corporations, state and local governments, and insurance companies. That is comparing these two. In the Bank of Canada statistical summary we publish monthly the figures of the total investment transactions of twelve life insurance companies which includes the breakdown of their securities of various types, one of which is Government of Canada bonds.

COMMISSIONER BROWN: I would like to go back to my question. I may be wrong, but I understand that in United States there are available figures for individual maturities of the combined holdings.

MR. RASMINSKY: By maturity? By indi-

vidual security?

COMMISSIONER BROWN: Yes -- of the combined holdings of the government and Federal Reserve accounts, and those were the statistics about which I was inquiring.

MR. RASMINSKY: Yes. I think that that is right, that the reporting system in the United States does throw up more information regarding the break-down by individual maturities of various classes of holdings. In order to get that information regarding the distribution of individual maturities it would require action on the part of some authority which had the power to call for such statistics. The Bank of Canada, in its statute, has no such authority. I suppose that it would be necessary for this information to be obtained, therefore, by government, if the information were desired.

COMMISSIONER BROWN: Presumably you have no problem in getting the statistics to which I was referring, which would be the holdings of the Bank of Canada and the government accounts. That is what I was asking for.

MR. RASMINSKY: You would like to know the Bank of Canada and government account holdings by individual issues?

COMMISSIONER BROWN: The point is that this is available in the United States.

MR. RASMINSKY: With a lag.

COMMISSIONER BROWN: With a lag.

MR. RASMINSKY: With a lag of several mohths. The Bank of Canada in its balance sheet publishes various classifications of its holdings of investments. We show separately treasury bills, other securities maturing within two years and securities not maturing within two years. That is given weekly, and then monthly this

last classification of securities maturing in longer than two years is broken down into securities maturing from two to five years, from five to ten years, and securities maturing in over ten years.

COMMISSIONER BROWN: Would there be any particular problems involved in giving this sort of information in great detail?

MR. RASMINSKY: I should like to think about that, Mr. Brown. There might be some problems in the sense that the information would have market implications. No doubt it is because they would have market implications that the figures would be desired, and it might not be desirable from the point of view of the central bank to make this information available.

COMMISSIONER BROWN: I am trying to find out whether there would be anything against the central bank's interest in making this information available with a time lag, or a similar time lag to that which exists in the United States. The fact is that at the moment it is not available at all.

MR. RASMINSKY: By individual issues.

COMMISSIONER BROWN: Yes, even on a six months' lag or a twelve-month lag.

COMMISSIONER MACKINTOSH: I would think that there is this point that the lag might be sufficient to wipe out the market implication, but if anybody wants to analyze what has been going on with respect to debt management policy and monetary policy they cannot get too far dealing just with totals. If they want to

see how the system actually has worked they need to be able to look historically, I would think, at what the Bank and the government have been doing in respect of --

MR. RASMINSKY: Individual issues?

COMMISSIONER MACKINTOSH: -- individual maturities, but I can see that you do not want to put it out with a two-day delay.

COMMISSIONER GIBSON: There is still a thought which suggests that debt management operations, the mere changing of maturities and refunding, have a marked effect on the average level of the whole interest-rate structure itself.

From this point of view I would think that the later disclosure of such figures would be very interesting and helpful. If you would care to express any view on the question of how far debt management policy can affect interest-rate structures, it would be appreciated.

MR. RASMINSKY: A view as to how far debt management --

COMMISSIONER GIBSON: I am referring to the general level of interest rates apart from monetary policy itself. As you are no doubt very well aware there is a rather growing school of thought that debt management, coordinated with monetary policy, can very closely and effectively change your interest rate structure. I would appreciate any comments you would care to make in that connection.

MR. RASMINSKY: I suppose, Mr. Gibson, it

would depend on the scale on which debt management operations were carried out and on what was happening at the time, in respect of the influences on credit conditions and the level of interest rates generally. If debt management functions were carried out -- and by debt management functions in this connection I had in mind a change in the maturity distribution of the outstanding stock of securities -- if these were carried out on a very large scale, if a concerted vigorous attempt were made in this way to change the slope of the interest rate curve in one direction or another, I think it is possible that the whole level of the curve could, to some extent, be affected.

COMMISSIONER GIBSON: Do you think this is an important consideration in national economic policy?

MR. RASMINSKY: I think that if debt management functions were carried out on so vigorous a scale as this, they could be quite an important consideration. I think that in a way the activities of the purchase fund were of this character in buying long-term securities in the market and ultimately, through the effect of this, in using up government cash resources requiring additional borrowing which took place in the short end of the market.

COMMISSIONER BROWN: Has the Bank made any study of the relative size of change of maturities that has an appreciable effect on various portions of the yield curve?

MR. RASMINSKY: Have we attempted to determine

what the magnitudes involved are?

COMMISSIONER BROWN: Yes.

MR. RASMINSKY: Only pragmatically, Mr. Brown, through such operations of this character as we have conducted, either as agent for the government or in our own switching activities.

COMMISSIONER BROWN: That is all I have on debt management, Mr. Chairman.

THE CHAIRMAN: Next?

COMMISSIONER LEMAN: Mr. Chairman, if we might turn to section V of the submission, which deals with foreign exchange, for which, by the way, the submission did supply quite a good bit of detail, I should like to refer both to the submission and to Mr. Rasminsky's statement on the opening day of this discussion.

I should like to start first with a few rather detailed questions on the subject matter. Does the Bank of Canada have knowledge of the extent, if any, of foreign exchange transactions that do not go through the chartered bank system?

MR. RASMINSKY: That do not go through the chartered bank system?

COMMISSIONER LEMAN: Yes?

MR. RASMINSKY: No, we do not have any information.

COMMISSIONER LEMAN: Is it suspected that there is a good deal going on or do you think it is fairly negligible?

MR. RASMINSKY: I do not believe there are

significant amounts of exchange business that are not conducted at some point or other through banking channels. Banking channels would include foreign banks as well as the chartered banks. There is no doubt that some exchange business is conducted, say, through travel agencies or express companies, but ultimately this retail business winds up in the banking institutions.

COMMISSIONER LEMAN: And even this share of the total transactions,as I gather from the submission, that might have been dealt with earlier by foreign banks has tended more and more to be handled in Canada through the Canadian chartered banks? Is that a fair statement or a correct understanding?

MR. RASMINSKY: Is the question, Mr. Leman, whether an increased proportion of the foreign exchange business conducted by residents of Canada is conducted through the Canadian chartered banking system as compared with the situation --

COMMISSIONER LEMAN: Some years ago.

MR. RASMINSKY: -- some years ago?

COMMISSIONER LEMAN: Yes.

MR. RASMINSKY: Yes, it is my general impression that that is the case. I would not be able to produce statistics to verify that, for we do not know how much Canadian dollar business is conducted abroad and we also do not know how much exchange business the banks conduct with their own customers.

Most exchange business, of course, is married off within an individual bank, and it is only the surpluses or the deficiencies that pass through the

inter-bank market, and the only statistical information we have relates to the turnover of exchange in the inter-bank market.

It is my impression that over a considerable number of years the system of foreign exchange control played an important part in such diversion of exchange business to the Canadian banks from foreign banks as has taken place. Under the foreign exchange control system,all foreign exchange transactions conducted by residents of Canada had to be conducted through an authorized dealer of the Foreign Exchange Control Board, and the only authorized dealers were basically Canadian banks. No foreign banks were authorized dealers, and I think that in the course of that time more and more the practice grew up on the part of Canadian corporations of doing their exchange business with Canadian banks. However, it is the case that a fair amount of Canadian exchange business is done with non-Canadian banks, but I would say that the exchange market for Canadian dollars is in Canada.

COMMISSIONER LEMAN: I gather from the last paragraph of appendix II that, as to the part that does not get through the inter-bank market, you can make a fair guess by inference from other figures?

MR. RASMINSKY: Well, we know, Mr. Leman, as regards all the current items in our balance of payments, which give rise to exchange transactions, what the gross figures are. We know what the imports and exports are, what the travel expenditures and receipts are, and we also as regards the capital items

have a good deal of knowledge, though in some cases that is on a net basis.

Not all of the international transactions, however, give rise to exchange business. There are private firms who prefer not to pay the difference between the buying rate of exchange and the selling rate of exchange and who operate foreign currency bank accounts where they do the netting and the off-setting themselves. But we have a pretty fair idea as to the general order of magnitude of the customer business in exchange, although, as I say, we do not know how it is distributed between Canadian and foreign banks.

COMMISSIONER LEMAN: You explain to us at the beginning of appendix II that the inner rim of the foreign exchange market consists of the head offices of the chartered banks. Is this just a matter of convenience or is there any compelling reason why the market should be restricted to the banks? Would anyone else be interested in becoming, you might say, an intermediary for foreign exchange transactions?

MR. RASMINSKY: You mean a broker?

COMMISSIONER LEMAN: Brokers, or dealers perhaps?

MR. RASMINSKY: Apparently no one has thought that he can make a living out of doing that. It has been perfectly open to anyone to set up as an intermediary. Everybody who does exchange business or who has occasion to engage in an exchange transaction has a bank account and deals with a bank, and I think it is quite normal and to be expected that the banks should be the exchange market.

COMMISSIONER LEMAN: Because at the end of the transaction there is a transfer of funds.

MR. RASMINSKY: That is right.

COMMISSIONER LEMAN: Does the Bank of Canada itself ever deal directly with any of the chartered banks or always through a Montreal or Toronto broker?

MR. RASMINSKY: All dealings are through the brokers.

COMMISSIONER LEMAN: What sort of reports of information does the broker supply to the Bank of Canada?

MR. RASMINSKY: The brokers inform us of the quoted prices in the market from time to time, and the prices at which actual transactions take place; and at the end of the day they inform us of that day's turn-over of foreign exchange in the market.

COMMISSIONER LEMAN: How do the brokers work in practice under the pegged rate of exchange system? Do they contact the Bank of Canada as soon as they cannot match buying and selling orders? Is that the way in which the Bank can keep within the one per cent plus or minus of the official pegged

rate?

MR. RASMINSKY: The Bank of Canada is one element in the exchange market which participates in the market technically on exactly the same basis as the other elements. The brokers in Toronto and Montreal have key switchboards to each of the chartered banks and to the Bank of Canada in Toronto and Montreal, and when an offering of exchange comes to the market from one bank the rest of the market will be informed through the broker that exchange is being offered at such and such a price. Then each participant in the market will decide whether he wants to buy that exchange or whether he wants to bid some other price for it.

The Bank of Canada, acting virtually in all cases as agent for the exchange fund, participates technically in the same way as every other participant, though the motivation of our participation will, of course, be different. The chartered bank will be participating basically because it needs the exchange to fill an order from a customer or because it has a surplus of exchange that it has bought from a customer, which it is not able to match off itself.

The participation of the Exchange Fund Account, carried on through the Bank of Canada, will be motivated by views as to whether it is desirable to keep the rate from moving in one direction or the other, or to acquire reserves, or give up reserves in the process of doing so.

COMMISSIONER LEMAN: What I had in mind was whether in practice what happens is that the Bank of

Canada rather operates as the last resort, when the brokers find that they can't cover a position which is getting large and indicates a trend in a direction, by dealing with the banks.

MR. RASMINSKY: In actual fact the Exchange Fund Account is basically the equalizing factor in the market in which surpluses of exchange that develop in the market are taken up in order to prevent the prices from moving in one direction, or deficiencies are provided in order to prevent the prices from moving in the other direction.

COMMISSIONER MACKINTOSH: You operate right through the spread, and especially at the limits. You would increase your operation at the limits, but you are actively operating right through the spread if prices move?

MR. RASMINSKY: The changes that have taken place in the reserve holdings during the period since the government decided to go on the fixed rate do indicate that the exchange fund has in fact operated within the spread, because the exchange rate has not reached the limit of the spread.

COMMISSIONER LEMAN: In paragraph 14 of section V, towards the end, in explaining your operations for various government accounts you say:

"The foreign currencies to supply these accounts are sometimes obtained in the local interbank market and sometimes in New York or London, but it is usually more advantageous as well as more expeditious

to buy foreign currencies from the central banks concerned in exchange for Canadian dollars or United States dollars."

What is the inference to be drawn from that? Is it the size of the transaction that makes it more advantageous or more expeditious to deal directly with the foreign central bank? Is it because the brokers in those foreign countries would also have to end up by dealing with their central bank, and you might as well cut the corner ?

MR. RASMINSKY: I don't think so. I think the implication of this is that there is a good market for United States dollars in every country, but there is not a particularly good market for the whole range of foreign currency in the United States or in Canada. You can get any currency you want against U.S. dollars in that country, but you may not find it possible or very easy to pick up some esoteric currency in the United States.

COMMISSIONER LEMAN: Is the implication that this remark I have quoted applies more to other than sterling or United States dollars?

MR. RASMINSKY: Which remark are you referring to?

COMMISSIONER LEMAN: That is the last sentence of paragraph 14. I had read it to mean that you might deal with the foreign central bank even sometimes when you are dealing in sterling or United States dollars, but now I gather the impression from your reply that you are referring to other foreign currencies,

other than those two.

MR. RASMINSKY: Yes. May I read the whole series of sentences?

We first refer to the bank transaction in United States dollars and sterling. Then we say:

> "In addition the Bank maintains accounts with central banks in a number of other countries. These accounts enable the Bank to make payments by cable and to issue drafts in the appropriate foreign currencies as required by government departments. The heaviest requirements are those of the Departments of Finance and National Defence ..."

Then we come to the sentence that you have been referring to: "the foreign currency to supply these accounts" -- that is the foreign currencies other than United States dollars and sterling --"are sometimes obtained in the local interbank market and sometimes in New York and London. But it is usually more advantageous as well as more expeditious to buy these foreign currencies from central banks concerned in exchange for United States or Canadian dollars."

COMMISSIONER LEMAN: I understand now. I thought it might apply even to sterling or United States dollars.

MR. RASMINSKY: No, it is not intended to apply.

COMMISSIONER LEMAN:
Now that we are under the pegged exchange rate system, does the Bank ever deal in forward exchange?

MR. RASMINSKY: The Bank does not normally

deal in forward exchange for its own account, although I don't mean to be taking any self-denying ordinances in that respect. The Bank, as agent for the Exchange Fund Act, has conducted transactions in the forward exchange market.

COMMISSIONER LEMAN: For instance, will it try to affect the spread between spot and forward rates?

MR. RASMINSKY: These transactions in the forward exchange market are, of course, undertaken by the Bank, like the transactions in the spot market, on the instructions of the Minister of Finance, whose money it is in the Exchange Fund Account. One of the considerations involved in undertaking forward exchange transactions might well be the spread between the spot and forward rates of exchange.

COMMISSIONER LEMAN: In paragraph 10, Mr. Rasminsky, of the same section -- I am sorry, I seem not to have the correct reference in my notes. There is a paragraph here which refers to the fact that the Bank is not authorized to pay interest on deposits from foreign agencies. I was wondering if I should read into the fact that it is mentioned an inference that the Bank thinks it would be better if it were authorized to pay interest, in circumstances where it would be advantageous and more convenient to do so.

MR. RASMINSKY: This was put in as a piece of description as regards the Bank authority. That is found in paragraph 15 at page 58.

COMMISSIONER LEMAN: Yes, I have it now.

MR. RASMINSKY: It was not intended to convey

any such inference as you have suggested.

COMMISSIONER LEMAN: Would you be prepared to comment on that? Would it afford certain advantages or simplify certain dealings you might have with these foreign agencies, if in your own judgment you were enabled or authorized to negotiate anything that would be reasonable?

MR. RASMINSKY: On occasions when it is appropriate to pay interest we do have and use an alternative technique which is referred to as "money employed". This technique was used, for example, in connection with some of our central bank arrangements entered into in the course of the last year. It is a technique under which the Bank of Canada sets aside certain securities, the interest on which is used to compensate the other party for leaving a balance with us.

In actual practice the "money employed" technique has not presented any difficulties, and I would not at the present time be inclined to feel that there was any particular value in asking that the act should be amended to give us the power to pay interest on deposits.

COMMISSIONER LEMAN: Am I right in thinking that other central banks suffer no such prohibition under their legislation?

MR. RASMINSKY: I don't know, Mr. Leman. I don't know what is the position of other central banks in this respect. If you wish us to do so, I would be glad to have a survey made of the arrangements

of other central banks and send it to the Commission.

COMMISSIONER LEMAN: I was not suggesting it was a matter of great concern, Mr. Rasminsky. I was just wondering about it.

MR. RASMINSKY: I am afraid I don't know what the arrangements are with the other central banks.

THE CHAIRMAN: We will take a few minutes recess.

--- Short recess.

THE CHAIRMAN: We will now resume.

COMMISSIONER MACKINTOSH: Mr. Chairman, I have one or two questions I would like to ask.

I think with your preliminary statement you explained the need for a larger reserve in managing a fixed exchange rate system, I take it, for the purpose of absorbing shifts in foreign exchange, while longer term measures may be taken if they are persistent?

MR. RASMINSKY: Right.

COMMISSIONER MACKINTOSH: It gives you some of the latitude that a fluctuating rate would give you, and you suggest that you think that given fairly large reserves, the manageability of large capital flows is quite feasible.

Without discussing particular instances, could you give any indication of the sorts of problems that would attach to managing these large capital flows?

MR. RASMINSKY: Under fixed rate conditions?

COMMISSIONER MACKINTOSH: Yes. I am just looking for some understanding, not for precise information.

MR. RASMINSKY: The problem would arise if the capital flow was not compensatory with a flow of funds resulting from current account transactions in the opposite direction. Clearly to the extent that there is an inflow of capital which balances a current account deficit, no parti-

cular technical problem arises.

COMMISSIONER MACKINTOSH: Capital flow that is pressing the exchange rate in one direction?

MR. RASMINSKY: That is right, capital flow that is pressing the exchange rate in one direction or the other.

I suppose one should look separately at the two cases where the pressure is of a character which we have by and large experienced since June; that is, pressing the exchange rate in the upward direction because the inflow of capital has exceeded the current account deficit, giving rise to transactions in the exchange market during that period of time.

In that case the inflow of capital results in an addition to reserves. This addition to reserves, as you indicated in an earlier question, Dr. Mackintosh, can take place at any point in the permitted range of variation in the exchange rate. It need not wait until the exchange rate has been pushed to the upper limit for the Canadian dollar.

The financial problem that this gives rise to, or the financial consequences of an addition to reserves, is in the Canadian dollars which are required to finance the addition to reserves. This is a point which I am sure is very clear to you but which ordinary people find difficulty in grasping.--

COMMISSIONER MACKINTOSH: Thank you.

MR. RASMINSKY: —that reserves require to be financed when the exchange fund, through the Bank of Canada, adds to its reserves; it is buying exchange from the exchange market and it has to pay for the exchange and it requires Canadian dollars to use for the purpose of paying for the exchange.

Under the system that we operate here, since the exchange is owned by the government of Canada, the Canadian dollar financing requirements fall on the government of Canada. Technically, the exchange is held in the exchange fund account and the exchange fund account is financed by advances from the Minister of Finance to the exchange fund account.

These advances constitute part of the active assets, they are classified as an active asset of the government of Canada. If the exchange reserves are increasing in the exchange fund account, then the Minister of Finance has to find additional Canadian dollars. These requirements become part of his general requirements of Canadian dollars, and he finances them in accordance with whatever fiscal programs or financial programs he has at the time.

If there is a budgetary surplus funds would be available from the budgetary surplus to finance these requirements. If there is not a budgetary surplus, then the Minister of Finance must borrow the money to finance them, and this

raises the same type of problem as any other Canadian dollar financing requirement of the Minister of Finance.

COMMISSIONER MACKINTOSH: Just the same as is produced by direct housing loans?

MR. RASMINSKY: Yes, just the same as is produced by direct housing loans, exactly. That is the general nature, I think, of the financing problem at that end of the spectrum.

At the other end of the spectrum, if the exchange fund is intervening in the exchange market and selling reserves it comes into possession of Canadian dollars and these Canadian dollars in the past have gone into the general pool of Canadian dollar resources available to the government of Canada for its overall purposes.

There was a limited exception to that statement in the course of this summer. During the period of the rapid run-down of exchange reserves the government came into possession of very large amounts of Canadian dollars; its Canadian dollar balances were at one stage, I believe, higher than they had been since immediately after the last victory loan. The government decided at that time as part of the program of emergency measures to deal with the situation to sterilize these balances and not use them for ordinary purposes. The purpose was to prevent these balances from getting into the private sector of the economy.

The run-up in exchange reserves subsequently was, as you know, very rapid and these

sterile balances were very soon used up to acquire reserves with, and I think by the month of August all of the government's Canadian dollar balances were "unsterile," so that was an exception for a limited duration of time.

The system is again one under which the loss of reserves results in an increase in the Canadian dollar balances of the government of Canada. That increase doesn't raise any particular financial problems, the financial problems involved at that end of the spectrum are those involved in the loss of reserves themselves, and the problems involved there depend upon the magnitude of the reserves and the magnitude of the losses, on the public appreciation of the significance of the losses and on what the underlying situation is.

COMMISSIONER MACKINTOSH: We had a suggestion, I forget from which of our witnesses it came now, that what was done in 1939, if I remember rightly, when the exchange fund was transferred from the Bank to the government, might reasonably be reversed, with the exchange fund transferred back to the Bank.

Now, without asking you to comment on the policy involved here, would this merely change the form of these problems or would it make any essential difference in relation to the movement of the exchange fund to the requirements of monetary policy?

MR. RASMINSKY: I think that basically

it would change the form of the problem without making any essential difference in the monetary policy field. I say that on the assumption that under either system the monetary policy will take fully into account -- as it is bound to do -- what is happening in the field of our international transactions and what is happening to our reserve movements, and that it will aim at encouraging credit conditions that are appropriate to the circumstances, including those particular circumstances.

There are other differences in the two systems, perhaps of a less fundamental character. If the exchange reserve were held by the Bank of Canada, the Bank of Canada would presumably make payment to the government for the exchange reserve and the government would be put in funds to retire debt, which is now held by the Bank of Canada, so that the effect of the transfer of reserves to the Bank of Canada would be that the gross public debt would be reduced by the amount of the transfer.

COMMISSIONER MACKINTOSH: Aside from other transactions, the proportion of it held by the Bank of Canada would be reduced?

MR. RASMINSKY: The proportion held by the Bank of Canada, quite so; the proportion held by the Bank of Canada would be reduced.

There would be no change as a result of this transfer in the net public debt outstanding because, as I mentioned before I believe, the advances to the exchange fund account are an active

asset of the government which is an offset to the gross debt.

Another difference that would be involved in this change which is implied in what I have just said is that the profits of the Bank of Canada would be reduced to the extent of the interest earned on the debt that would be paid over to the government. This again is a wash transaction because the profits are in any case paid to the government, and the offset to that is the earnings on the assets in the exchange fund account which would become earnings of the Bank of Canada. I think that those are the main differences.

Technically, of course, the two systems would work differently. If the Bank of Canada held the exchange reserves, then a loss of reserves would result in a contraction in the amount of central bank money outstanding. It would result in a contraction in the deposits of the chartered banks with the Bank of Canada, and the chartered banks, to put it the other way around, would be using deposits with the Bank of Canada to buy exchange from the Bank of Canada.

COMMISSIONER MACKINTOSH: You would have to offset that?

MR. RASMINSKY: The Bank of Canada would then have to offset that to the extent that monetary policy considerations dictated by acquiring securities in the market.

COMMISSIONER MACKINTOSH: Now, without

asking you the question how large the reserves should be, I take it the case for a considerably larger reserve is basically that one wouldn't want to be in and out of the International Monetary Fund with great frequency, but that is a more remote source of support and need, nor would one want to have recourse frequently to special loans. Are the reciprocal arrangements between central banks, are these to be looked on as emergency measures or continuing measures? I am speaking of them generally and not asking any particular question about Canada?

MR. RASMINSKY: You know that we have no reciprocal arrangements outstanding at the present time. When I say we have no reciprocal arrangements outstanding, there is no cash outstanding, there is no cash involved in the present arrangements. We do have a stand-by arrangement with the Federal Reserve System for $250 million. I believe that the central bank swaps or other reciprocal currency arrangements are becoming a permanent part of the institutional framework in the monetary system.

COMMISSIONER MACKINTOSH: Again without reference to the Canadian position, is the question of the allowable spread of one per cent under the I.M.F. rules -- is the questinn of the possible desirability of a wider spread, is this an active question generally in the I.M.F.?

MR. RASMINSKY: No, it is not.

COMMISSIONER MACKINTOSH: Or is it a dead duck?

MR. RASMINSKY: The one per cent spread is incorporated in the articles of agreement of the International Monetary Fund, and it would require an amendment to the articles of agreement involving legislative action in all the member countries, and no consideration whatever that I am aware of is being given to altering the one per cent spread.

COMMISSIONER MACKINTOSH: We have had various suggestions about gold. Is the amount of gold held in the Exchange Fund just the result of the gold that comes in from the Gold/Mining Assistance Act or is it a matter of rational and deliberate government procedure?

MR. RASMINSKY: The amount of gold held in the exchange fund account is a matter of government decision.

COMMISSIONER MACKINTOSH: Which is made, I suppose, from time to time. Would you care to express any views as to the adequacy of the various steps which I think are described somewhere in the paper to improve international liquidity arrangements, and whether you see the prospect of further progress?

MR. RASMINSKY: The steps that have been taken to improve international liquidity arrangements can be thought of as falling under various headings. The major improvement in the international liquidity position which has occurred in the world in the past ten years has, of course, been the result of the balance of payments deficit of the United States. Very substantial increases have occurred in the dollar holdings of foreign countries. It is odd to think that it is only a few years ago that they were talking about the chronic scarcity of American dollars; and now the international liquidity position has been very greatly improved as a result of the American dollars made available to the rest of the world through the fact that American foreign aid, capital exports and military assistance expenditures abroad have exceeded even the very large current account surplus that the United States has gone on earning year after year.

COMMISSIONER MACKINTOSH: And any reversal of that would decrease liquidity?

MR. RASMINSKY: Any reversal of that would have the effect of drawing dollars back from foreign countries into the United States and, consequently, decreasing liquidity. But that is the basic natural improvement which has taken place in the world liquidity position.

The International Monetary Fund has played a very important role, in my opinion, in improving the international financial structure. The Fund was originally established with quotas, with a pool of

resources, which grew to about $10 billion, and four or five years ago, as you know, the various members of the Fund undertook to increase their quotas by 50 per cent, with special increases in the case of certain countries, including Canada. So that the total of quotas in the Fund is now something like $15,000 million. $15,000 million of liquidity in the Fund is worth a good deal more than $15 billion of liquidity elsewhere, because it can be pin-pointed. It is a mobile pool of resources that can be drawn on as needed and restored to the Fund as the drawing country's payments position is improved. It is a revolving fund.

Not all this $15 billion, I should say, is in truly usable resources; some of it is in minor currencies that would hardly be drawn on; but the great bulk of it now is in truly useable currencies, or in gold.

In addition, within the last year a special fund associated with the International Monetary Fund has been established by the major industrial countries of the world -- the ten major industrial countries of the world, including Canada -- though steps have not yet been taken by Canada to provide the necessary legislative authority for our participation in this fund. This fund, amounting to $6 billion, is basically to be used for the purpose of offsetting short-term international capital flows which have become of increasing importance since the re-establishment of convertibility of currencies, the progressive re-establishment of convertibility of currencies in the past

several years and the establishment of formal currency convertibility by the major European countries within the last few years. This will constitute as an important addition to the international institutional framework.

COMMISSIONER MACKINTOSH: You would think that up to the moment these were pretty adequate provisions, and if future needs run beyond this these can be increased?

MR. RASMINSKY: I think at the present time that apart from any questions of the distribution of international liquidity, the amounts provided through the owned resources of the major countries and that can be provided through the institional framework -- which includes the central bank credits, the currency swap arrangements we were talking about -- are adequate.

It is the case, however, that the further additions to the pool of international liquidity arising from some of these sources, and in particular from further additions to foreign holdings of U.S. dollars, can hardly be expected to continue in view of the balance of payments position of the United States --

COMMISSIONER MACKINTOSH: In fact, they may well shrink.

MR. RASMINSKY: It is possible that they would shrink. Consequently, it seems to me that one should have an open mind towards proposals for further development in the international institutional framework to provide for future needs for liquidity as world trade and world population expand.

COMMISSIONER MACKINTOSH: Thank you, that is

all I have.

MR. RASMINSKY: Before you leave this range of questions, Dr. Mackintosh, there is one point in connection with the question you asked as to the location of the exchange reserves which I should have made and which is associated with it. It is that wherever the exchange reserves are located, whether they are located with government or with the Bank of Canada, the basic decisions regarding exchange policy, including the fixing of the exchange rate, are the decisions of the government of Canada and not the Bank of Canada.

COMMISSIONER GIBSON: Mr. Rasminsky, might I ask you one more question in that connection? Would the change in the location of the holdings under the alternative plan inhibit your open-market operations by reducing your security holdings?

MR. RASMINSKY: No, I do not think that that would be an inhibiting factor. It would depend upon the amounts involved. It would depend on how much was transferred, what the reserves were at the time, and what proportion of them was transferred to the Bank of Canada. If the entire reserve was transferred to the Bank of Canada, then this would leave us very short of securities.

COMMISSIONER GIBSON: That is the way it looks to me.

MR. RASMINSKY: Yes, on the arithmetic, that is quite right.

COMMISSIONER LEMAN: Mr. Rasminsky, would it be true to say that if one holds large reserves --

and Dr. Mackintosh said that he would not ask you how large "large" was -- would it be true to say that if one holds large reserves he creates conditions for domestic policy which approach those under a floating rate system? In other words, you let your whole system absorb whatever shocks there are. I thought I drew that inference from your statement here.

MR. RASMINSKY: No, I do not think so. I think that large reserves give you more leeway; but under either system, whether you have a fixed rate system and take fluctuations in reserves, or whether you have a fluctuating rate system, with the impact of imbalance in the foreign exchange account coming on to the exchange rate rather than on to the exchange reserves -- I think that in either case you would have to be concerned in your policies with what is happening to your international accounts, whether reflected in exchange reserves or in exchange rate. It may be that really the answer I should have given to your question, the short answer to your question was: Yes, that the two systems are similar, not in the sense that large reserves give you freedom to disregard international considerations, but rather in the sense that you do not have that freedom under a fluctuating exchange rate anyway.

COMMISSIONER LEMAN: Dr. Mackintosh said that he would not ask you how much "large" reserves for Canada would be, and I do not intend to ask you that either, but I would like to ask you if there is a way in which one, say in this role as adviser to the

government, could arrive at a good answer, without stating any amount right now. Is there a particular approach to arriving at the right answer?

MR. RASMINSKY: By reflecting on it! I do not think that there is any formula, Mr. Leman, that one could suggest. Various formulae have been suggested by those who have looked at the broad problem of the adequacy of national reserves. Some might say that a country should aim at reserves equivalent to three months' gross imports. Others might say a country should aim at reserves equivalent to half a year's imports. Some might say that a great deal depends on the level of the current account; and another consideration is the extent of the country's international indebtedness, and the speed with which policies will respond to movements in reserves.

I think that these -- and, no doubt, many other considerations that I have not mentioned -- can be thought of, but I do not think myself that there is any precise formula that can be used to determine the adequacy of reserves.

COMMISSIONER LEMAN: But any such determination would take into account the fact that there is, in reserve, behind that, the access to the International Monetary Fund, swap arrangements between central banks, etcetera?

MR. RASMINSKY: Yes, that is right. I think perhaps a general principle that one might think of is that one would like to see reserves that were large enough to withstand losses resulting from the normal

imbalances that may take place over a period of time in the exchange market and still leave enough to provide time for policies to be worked out which will restore these imbalances.

THE CHAIRMAN: The only further subjects that we have to deal with, Mr. Rasminsky, are first, the organization of the bank and information as to the staff and so on, and also the relationship between the Bank of Canada and the government which involves a number of questions and probably will result in some discussion. So, I think we had better adjourn now until Monday at 9:15 a.m.

MR. RASMINSKY: Good!

---Adjournment.

Ottawa, Ontario,
Monday,
January 14, 1963.

--- Upon resuming at 9.15 A.M.

--- Commissioner Mackintosh absent.

THE CHAIRMAN: I call the meeting to order. Mr. Harrold?

COMMISSIONER HARROLD: Mr. Rasminsky, I have a few questions on the management and organization of the Bank. We have had some suggestions as to the Board of Directors, and we may start off there. Just a word about the present Board, its role and functions. In your submission there is not too much said about how the Board of Directors and management operate. The opening sentence reads:

> "The responsibility for the affairs of the Bank of Canada rests with a Board of Directors composed of the Governor, the Deputy Governor and twelve Directors."

You say that the present Board has diversified occupations, but I think it has turned out to be more than that: it is regional; there are two directors appointed from the province of Quebec, two from the province of Ontario, and one from each of the other provinces. You also say that the Board normally meets eight times a year. Could you tell us a little more as to the responsibilities of the

Board of Directors, and what the Board actually does in the transactions and business of the Bank now? In other words, what is considered at Board meetings, and how far do you actually go into the administration and operation of the Bank?

MR. RASMINSKY: Yes, I would be glad to do that, Mr. Harrold. As you know, apart from the Governor, the Deputy Governor, and the Deputy Minister of Finance, who is ex officio a member of the Board, twelve persons are appointed by the Minister of Finance with the approval of the Governor in Council for 3-year terms. The act specifies that the directors of the Board shall be of diversified occupations. The act itself does not specify that there shall be regional representation on the Board of Directors, but in actual practice the directors of the Board at the present time -- and I believe that this has been the case since the Bank was nationalized -- include one person coming from each of the provinces, with the exception of Ontario and Quebec, and there are two persons on the Board from each of those provinces.

The main functions of the Board which are specified in the act and which do, in fact, constitute, in my judgment, one of the most important if not the most important functions of the Board, are functions which are related to the management of the Bank. The directors of the Bank appoint the Governor and the statutory Deputy Governor. These two appointments require the approval of the Governor in

Council. In addition, the Board has the power to appoint additional deputy governors. That power is set out in Section 7 (1) of the Bank of Canada Act, which reads:

> "The Board may appoint one or more Deputy Governors who shall perform such duties as are assigned to them by the Board."

Other specific powers related to the management of the Bank, which are set out in the act to be performed by the Board or by the Executive Committee, which acts in regard to matters within the competence of the Board when the Board is not meeting, are set out in Section 15 (1) of the act, which reads:

> "Such other officers, clerks and employees may be employed as in the opinion of the Executive Committee may be necessary."

In general, the Board, acting either on its own behalf or through the Executive Committee, exercises a control over the salaries that are paid in the Bank.

I have gone into these matters in some detail, Mr. Harrold, because as I indicated before, I think that a primary function and a primary responsibility of the Board is to be satisfied at all times with the quality of the management of the Bank.

The members of the Board and the members of the Executive Committee -- and here I would like to say, in parenthesis, that though the act itself provides that there shall be one executive director

selected by his fellows to sit on the Executive Committee, which meets weekly, in actual fact there are almost invariably two members of the Board who attend meetings of the Executive Committee, the reason for this being that in the case of the I.D.B. act provision is made for two executive directors, and the meetings of the Executive Committee of the I.D.B. are held immediately after the meetings of the Executive Committee of the Bank of Canada. So that the director who is also executive director for the I.D.B., also attends meetings of the Executive Committee of the Bank of Canada, as well as, of course, any other director who is in Ottawa at the time.

The members of the Executive Committee and the members of the Board have quite frequent opportunities to see the top staff of the Bank in action, to form their judgments as to whether they are people of competence and intelligence, and to form a judgment as to whether the management of the Bank is up to its responsibilities. This is a function which is not too easy, which requires men of affairs, men of experience who are accustomed to judging others, to forming opinions of this sort.

If the Directors of the Bank came to the conclusion that the management of the Bank was not performing its functions adequately, then it would be the case that the Directors of the Bank would have a responsibility to do something about that. This I conceive to be one of the main functions of the

directors of the Bank; as, indeed, I would expect that it was one of the main functions of the outside directors of almost any organization. By "outside directors" I mean directors who are not engaged full time in the business of the organization.

In connection with this management function, before I leave that, there are other more specific functions that are performed by the directors of the Bank. I have mentioned that the directors of the Bank exercise a control over the salaries that are paid in the Bank. Generally, in the exercise of control over the whole economy and efficiency of the Bank's operation, the directors examine the administrative budget of the Bank which is submitted to them, and they examine, in the course of the year, progress reports that are made in relation to the administrative expenditures of the Bank.

Apart from this function of having this responsibility for the quality of the management, and this rather more detailed specific responsibility in relation to expenditures, the directors of the Bank perform certain other functions which, I think, are very important in the life of the Bank.

The diversification of the Board, the fact that the Board consists of people coming from each province, enables the Governor and the management of the Bank to have access to information, to views regarding developments in all parts of the country, information -- and this is not, of course, the only source of information that we have, but it is a valuable

one -- information regarding the impact of Bank policies in various parts of Canada, and the attitudes towards the Bank and its policies in various parts of Canada.

Another role that I have found the directors have played -- and this was one that was referred to by Mr. Towers in his submission -- is to encourage and support the Governor. I have found, in the time that I have been Governor, that the support of men chosen not by myself and coming from all parts of Canada, and the advice that I could get from them, have been of great value to me in giving me courage when it was needed to discharge my own responsibilities.

One question which I am sure that you and others would have in mind in this respect would be to obtain information as to the precise role that the directors of the Bank play with regard to monetary policy. I think that perhaps I should add something about that. The act itself does not define specifically any role for the directors of the Bank in this connection. It seems quite obvious from some other provisions of the act, and in particular from the obvious intention of the legislator that the directors should be a part-time body meeting not more frequently than seven or eight times a year -- I say that intention is obvious because the act provides a limitation on the expenditures that can be made in respect of directors' meetings, and this limitation would not permit, broadly speaking, of meetings much more frequent than the seven or eight

times a year -- it seems obvious from the act that the legislator did not intend that this body should initiate or conduct monetary policy. It seems obvious from this and other provisions of the act that the formulation and conduct of monetary policy was intended to be carried on by the Governor of the Bank on behalf of the Board of the Bank. I think, however, it would be a serious mistake to reach the conclusion from this that the directors of the Bank do not play an important role with respect to monetary policy. The Governor of the Bank, in reaching his decisions -- after the processes of discussion that take place within the Bank or within government with regard to the general economic picture, the financial outlook, or specifically on monetary policy matters -- knows that he will have to explain and justify the policies that he has followed to this group of men, and the meetings with the directors are frequent enough that the Governor is aware, I think at all times, of what the general thinking of the directors is with regard to these matters.

Now, it is certainly the case that the thinking of some directors would be much more general than others, because some directors have much more expertise in this field than others. Nevertheless, the Governor is constantly aware that he must explain, that he must justify, that in a very real sense he must have the support of his Board in the policies that he is following. At any rate, this is the way that I look at the matter. I think that the directors

of the Bank, even without operational responsibility, do play an important part over a period of time in regard to monetary policy. This part is played, basically, in the way I have indicated: through a process of explanation, of examination of what happens; through an indication given at Board meetings of what the general outlook of the Governor is towards the monetary and financial situation, towards the economic situation; through the reactions that they have to the policies that have been followed and to the outlooks that the Governor has expressed.

COMMISSIONER HARROLD: I gather then, Mr. Rasminsky, that you do not have any special meetings outside of the more or less regular meetings seven or eight times a year? What I am thinking of is, in the case of what we call a crisis or a special situation you do not at any time call a special meeting of the Board of Directors to consider it?

MR. RASMINSKY: There have been no special meetings called during the period I have been Governor, Mr. Harrold.

COMMISSIONER HARROLD: In the operation of the Board meetings, have you had many formal votes -- or is that a question you would like to answer?

MR. RASMINSKY: No, I do not object to answering that question, Mr. Harrold. In all these answers I would like to make it clear that I

am speaking only of the period of my own personal knowledge. In other words, I am speaking only of the period of the last eighteen months. There have been formal votes taken in the sense that motions have been proposed and seconded, and the Governor has asked for a show of hands of the directors.

Having given that formally correct answer, I should add that within my experiences I have regarded such procedure as a formalistic procedure. The process of discussion has, in every case that I am aware of, revealed a concensus of view among the directors on these matters, and I cannot think of any instance in which this taking of the vote has resulted in a division within the Board of Directors.

COMMISSIONER HARROLD: Would you like to comment then on the merits of a somewhat larger board, composed of people of diversified occupations and as well people from financial institutions, such people to serve either on the board or on an enlarged executive committee? Do you think there would be any merit in such an enlarged board? As you know, the Bank of England has a somewhat larger executive committee than we have. Is there any merit to that type of a Board of Directors as it would apply to our particular situation in Canada?

MR. RASMINSKY: I think one would want to know what were the objectives sought through an enlarging of the Board.

The present Board consists of 12 appointed representatives and 3 others, 15 persons in all, who sit around a table. That Board is of a size that lends itself to discussion. It consists of persons of diversified occupation - this is one of the qualifications in the act. So, I think one would want to know what additional qualities one would get by enlarging the Board.

I know it has been suggested that the Board should include some people with financial background, financial expertise, that such people might be able to make a particularly valuable contribution to the work of the Bank. I think a well balanced Board should include people of financial background and financial expertise. In fact, it has always been the case that there have been some such people on the Board of Directors of the Bank of Canada.

At the present time there are included among the members of the Board a number whose primary or secondary interest has been along these lines. As you are I am sure aware, our directorate includes a retired president of one of the chartered banks, Mr. Ashforth; it also includes four persons who are also directors of insurances companies at the present time; another is a director of a trust company; one is a director of a provincial savings bank; and another is a director of a municipal finance company - I refer to Mr. Patrick, who is a director of the Alberta Municipal Finance Corporation. I do not know whether you would record this as financial expertise from this point of view, but one director is a chartered accountant, and another is a chartered accountant who devotes all his time to the manufacturing business.

I do believe that a well balanced Board would include some people of expertise in financial matters. I would not have thought that it would be necessary to enlarge the Board in order to achieve this result. The government has a free hand as to who

it shall appoint to the Board, and consistent with appointing people from the various provinces, as is always done, I would have thought if the government considers it wise to do so, more individuals whose careers have been or are in the financial field, could have been appointed to the Board.

I would like to conclude this answer by saying that while I think it is desirable to have financial expertise on the Board, going back to what I said at the beginning I do not think that you would look to the Board primarily for financial expertise. In my judgment you would look to the Board for the broad intelligence and wisdom and experience that enables it to judge whether the Bank is being well run or whether the policies of the Bank are, broadly speaking, of an appropriate character.

COMMISSIONER HARROLD: Would you say then that the discussion in the Board meetings might be limited if some active presidents or executives of financial institutions were appointed to the Board?

MR. RASMINSKY: As I am sure you are aware, the act itself provides otherwise ....

COMMISSIONER HARROLD: It excludes the chartered banks.

MR. RASMINSKY: Section 10 provides that no person is eligible for appointment to the Board of Directors who is a director, officer, or employee of a chartered bank, and that any person appointed as a director who is a shareholder of a chartered bank, shall divest himself of the ownership of the shares.

The directors of the Bank are required to take an oath of secrecy, under the provisions of the act. The functions of the Board being what they are, I would not consider that there need be any basic incompatability between active participation in a financial institution and membership of the Board. The Board has, indeed, from time to time had certain chief executives of large insurance companies as members of the Board. In the past there has been occasion where the Board included an active investment dealer. There is nothing in the experience of these matters that suggests that there is any incompatability.

COMMISSIONER HARROLD: With respect to these suggestions, you have commented fully and told us what the present function and role of the Board of Directors is; you have covered it pretty completely to my satisfaction, except for one thing that I would like to point up.

Do you think there is any merit in having a larger executive committee composed of people who have been active in the chartered banks? I realize there could be a conflict of interest there. Let us take financial people generally who are interested in finance in a general way and who have financial expertize - do you think there is any merit in an enlarged executive committee composed of people of this type?

MR. RASMINSKY: I would prefer to give a more considered reply to that question, Mr. Harrold. The implication of your previous question, that there must be some incompatability of interest, could arise

in relation to the executive committee, in a form in which it does not arise in relation to the meetings of the Board. The executive committee meets more frequently than the Board; it is therefore, through the process of reporting and discussing, closer to the thinking of the Governor regarding market developments and marketing possibilities. The executive committee is generally more active than is the Board. The question does arise in that form, but I don't think there is any incompatability there either; indeed one of the executive directors of the Bank who played a very active role in the life of the Bank was one of the chief executives of an insurance company, and there was at no time any suggestion of any incompatability there.

THE CHAIRMAN: I suppose there would be difficulty if an executive officer of a chartered bank were permitted to become a director?

MR. RASMINSKY: Yes, I think there would be difficulty.

THE CHAIRMAN: Because the chartered banks from time to time are, I suppose, at arms length with you?

MR. RASMINSKY: That is true, in a sense, and sometimes a pretty long arm.

In a sense, Mr. Chairman, in the conduct of the Bank's monetary management the chartered banks are the object of the exercise. It is through the chartered banks that the central bank exercises its influence on the monetary system. I would, therefore, regard this relationship as inconsistent and incompatable, and I

would guess that the chartered banks would take the same view.

COMMISSIONER LEMAN: A chartered bank with representation on the Board could not argue that it had not got clear signals.

THE CHAIRMAN: On the other hand, it is perhaps unfortunate that the one financial group that is so closely connected with the monetary policies and functions of the Bank of Canada are excluded, because they come closest to having the expertize in the particular functions that you perform.

MR. RASMINSKY: Yes -- expertise is one thing, Mr. Chairman, and what you are trying to accomplish is something else. I think expertise is a necessary ingredient of the mixture, but I don't think one could really count on the central bank and the chartered banks seeing eye to eye on those matters at all times. Frequently, they do, but there have been occasions when they did not.

The fact that the chartered banks are not represented on the directorate of the Bank of Canada or on its executive committee, by no means implies that the Bank does not regard it as very important to keep track of the thinking of the chartered banks, and what are the reactions of the chartered banks to the central bank policy, or what may have been the ideas of the chartered banks for improving the functioning of the monetary system.

We do that in various ways: some of them are continuing procedures, and some are on an ad hoc

basis. Of the continuing procedures, the ones that I think of at the moment are these: I have instituted the practice of meeting a minimum of three times a year with presidents of the chartered banks for a general exchange of views. These meetings have not only been pleasant but have been very useful as far as I have been concerned.

Secondly, there are regular quarterly meetings with the executive council of the Canadian Bankers Association. The council of the Canadian Bankers Association, as you know, consists of the general managers of the chartered banks. Every three months Mr. Beattie and I, and perhaps one other member of the senior staff of the Bank, meet with the general managers. For the most part we talk about monetary developments that have taken place since our last meeting; we may exchange views on what the economic situation appears to be, and deal with any specific questions that have arisen since our last meeting.

Preparatory to these meetings, the economists from the chartered banks usually visit Ottawa and spend an afternoon with some of the senior staff of the Bank, including the senior staff of the Research Department of the Bank. On those occasions we usually put on what we call in the Bank a "chart show", throwing up on a screen pictures of the behaviour of the various economic indices. This stimulates a discussion which permits of exchanges of information, and in some cases exchanges of views. This is what I would describe as routine or organized contact between top management

of the chartered banks and the Bank of Canada.

In addition to that, there is a fair amount of "to-ing" and "fro-ing" between Ottawa, Toronto and Montreal, where the main offices of the banks are located. I am happy to say that it is not all "to-ing", but there is some "fro-ing", that some of the senior officers have been good enough to pay visits to Ottawa, including delightful occasions when they have nothing on their minds and just come in to talk.

I would like to see more of this. I think that the location of the Bank in Ottawa, which is inevitable, does mean one has constantly to work at the establishment of this sort of very useful contacts. I think we are doing a fair amount of it; I think we should be doing more of it.

THE CHAIRMAN: In addition to the chartered banks, would you also include the money market dealers as a group that would not be eligible for appointment to the Board of the Bank?

MR. RASMINSKY: Of course, they are eligible, as you know, under the Act.

THE CHAIRMAN: Yes, they are not excluded, but would there be a conflict of interest there?

MR. RASMINSKY: Well, my hesitation in replying to this question is perhaps indicative of the fact that I don't think there is any inherent or necessary conflict of interest. On the other hand, it is the case that the only elements in the financial community with which the Bank has business relationships of a continuing character are the money market dealers. We have arranged lines of credit to the money market dealers in an aggregate amount - which I have undertaken to supply you with - which are quite considerable. The relationship of one of these lines of credit to another, the credit for one dealer relative to another, is a matter of some consequence to the dealers, and I would like, if I may do so, not to answer the question any further than that, at least at this stage, Mr. Porter; I think that it does raise some

questions for the Bank, which the membership on the board or the executive committee of financial institutions with which we don't have business relationships does not raise.

THE CHAIRMAN: Well, it has just been pointed out to me that Lord Cobbold told us when he was giving evidence that he wouldn't want members of the discount market on his board; that is the attitude they take over there.

COMMISSIONER LEMAN: Is it fair to ask you if it has been the practice of governments to consult with the Governor on the appointment of board members?

MR. RASMINSKY: Again, I can speak only on my own experience, Mr. Leman, and the answer to the question is affirmative.

COMMISSIONER HARROLD: Affirmative?

MR. RASMINSKY: Yes, but if I can just complete the answer, it would not be right to take the implication from that that the Governor has played a predominant role or necessarily an active role in connection with appointments, but the Governor has been consulted during my experience.

COMMISSIONER HARROLD: Do you think there is anything to the suggestion that the government is rather limited in its choice of directors for the Bank of Canada because of the number of directors that are appointed to chartered banks?

MR. RASMINSKY: Well, you are touching me at a vital spot there. We recently lost a director to a chartered bank -- which I shall not name in case I seem

to be critical -- whom I was very sorry to lose, although he has been succeeded by a very estimable man.

I would like to answer the question this way, Mr. Harrold; that in spite of the large size of the Boards of Directors of many of the chartered banks and the number of individuals who are thereby excluded from possible membership on the Board of the Bank of Canada, I don't think that that size is so large as to make impossible the task of finding a fully qualified Board of Directors to perform the functions that the Directors on the Bank of Canada should perform.

THE CHAIRMAN: To quote Lord Cobbold again, he said that he had made an arrangement with the banks in Great Britain that they wouldn't appoint too many people to their boards.

MR. RAMINSKY: I must talk to him about that!

COMMISSIONER HARROLD: I think the way he put it, he put the finger on them first and asked that they be left off the list of some of the banks.

COMMISSIONER BROWN: I was going to ask Mr. Rasminsky if the prohibition of shareholders of chartered banks really meant anything or, to reverse it a little bit, if being a shareholder was apt to constitute a conflict of interest as far as directors' operations are concerned?

MR. RASMINSKY: How many shares? I really don't think, as a practical matter, that it is, Mr. Brown.

COMMISSIONER BROWN: Thank you.

COMMISSIONER HARROLD: I have one or two

questions on the personnel - excuse me --

COMMISSIONER GIBSON: I don't want to appear interested, Mr. Rasminsky, but - I haven't finished my statement! - have you ever considered the appointment of economists to the Board of the Bank of Canada? I mean, is this an area that might be considered? I can remember one, but there haven't been very many to my recollection.

MR. RASMINSKY: Of course you realize, Mr. Gibson, I don't appoint the Directors of the Bank of Canada.

COMMISSIONER GIBSON: I do, but as an appropriate kind of person; that is why I said I didn't want to appear interested.

MR. RASMINSKY: Some of my best friends are economists! I certainly would be very pleased if a competent economist were appointed to the Board of the Bank of Canada.

COMMISSIONER HARROLD: You don't think that would add to your diffculties?

MR. RASMINSKY: No, I think it might subtract from them; it would provide at least one economist who was not publicly critical of the policies of the Bank!

COMMISSIONER GIBSON: That has been --

MR. RASMINSKY: Excuse me, Mr. Gibson; there has been at least one professional economist on the Board of the Bank of Canada; this was before my day, but this was Pete McQueen, and I am told he was a most excellent director and made a very valuable contribution to the Bank.

COMMISSIONER GIBSON: What I had in mind in asking this question is that you stressed earlier that one of the functions of the Board of Directors was to assess the quality of the staff, and how the senior members of the staff of the Bank are usually engaged in what you call central banking operations as such, and you have stated that the Board does not discuss in detail matters of monetary policy. Now, I am just wondering if you feel that the Board --

MR. RASMINSKY: I am sorry, but I don't think I really did make that statement, Mr. Gibson.

COMMISSIONER GIBSON: Well, may I strike it from the record, then, that they do not discuss matters of monetary policy, but you have stated that you have this Board of Directors which considers the quality of the staff. Now, the question I am really trying to get at is do you think there is any great disadvantage in the Board chosen from a wide group, mainly the business community across the country, in assessing capacities in the realm of central banking operations? That is why I asked you if you thought an economist on the Board might be useful.

MR. RASMINSKY: Well, as I say, I think that what one wants is the combined wisdom and experience in these matters of people of experience whose backgrounds differ. In that combination I have indicated that I think it would be useful to have representatives - not representatives, because the members of the Board are not there in a representative capacity - but people whose background is in finance.

For the same reason I think that it would be useful to have someone from the universities on the Board, but if the implication of the question, Mr. Gibson, is that it requires a degree in economics and some post-graduate work, --

COMMISSIONER GIBSON: That is not the implication; I was merely asking a question.

MR. RASMINSKY: Fine; I will not deal with the implications, then.

COMMISSIONER LEMAN: He might bring along his own charts to throw on the screen!

COMMISSIONER HARROLD: I have no more questions on the directors but I have one or two questions --

COMMISSIONER GIBSON: I would like to ask you if you think that we have anything in particular to learn from the American way of doing this; having a board of full-time governors, full-time directors, whatever you want to call them, as the centre of the central banking system. Would you care to make any comments on their way of operating?

MR. RASMINSKY: I think we have something to learn from the experience of the United States and every other country in this, and I would like to feel that we would keep an open mind on any procedures that would improve the quality of performance.

The particular one that you are referring to is a system in which there is a Board of Governors instead of there being a Governor who is responsible, that there is a Board of Governors where the responsibility rests. Obviously, such a system is a possible one and that

apparently works in the United States, and there may be other countries where reponsibility is vested in a group of men instead of being vested in one man.

I am not attracted to this system. I would like to think of this in two parts: one, the help and the advice that the head of the institution gets from the people that are permanently associated with the institution and, two, the locus of the responsibility for the conduct of the policies of the institution.

So far as the former is concerned, that is, the extent of the advice that the Governor gets from people who are identified with the institution, I am in favour of getting all the advice and all the help that I can, and I do so in the Bank.

We have each day - and I consider this a very important, in fact, the central part of my daily program and would make no engagements that I could possibly avoid / that would interfere with it - I have each day at 11 o'clock - that is, on days that I am not giving evidence - a meeting of the senior staff of the Bank, where we go around the table and first consider what has happened, what the cash position of the chartered banking system is, what is happening in security markets, what may be coming along by way of new government issues, what has been happening in the security markets outside Canada, what has been happening in the foreign exchange markets, what has been happening in the world generally, and I mean reports from the head of our research department and the new facts that have come to light in the course of the day; reports on attitudes that have been expressed

by these various individuals which we have been in contact with, and I consider that this is a great help to me. It provides me not only with the information, but it provides me with a group with which I am constantly in touch and assessing how monetary policy is working, where ideas can be threshed over as to whether we are going along the right lines or whether we have been doing a bit too much or perhaps not enough, and perhaps a change of one sort or another is indicated. So, from that point of view, from the point of view of getting the help, getting the advice, I like this, I am all for this group system.

From the other point of view of locating responsibility, it seems to me that at least in our situation -- I want to be careful of the way I put this because I don't want to appear to be critical of the way this operates anywhere else and where I say it does seem to operate --

-- it seems to me, in our situation, that the Governor should be held responsible, or that somebody should be held responsible, for the conduct of policy, and that it would make for a situation that was lacking in clear-cutness if the institutional set-up was one that made it possible for the Governor to be over-ruled, and to go along with views that he did not fully share.

Under our system the Governor, in making up his mind, naturally takes into account the views of others, but finally is left alone with his responsibilities, and he makes up his mind, and by making up his own mind is prepared to answer for what he does.

I do not know how these other arrangements work in practice. I do not know whether in actual fact it may not be the case that the head of the institution has characteristically carried the day. I am inclined to think that that may very well be the way they work in practice.

COMMISSIONER GIBSON: Now what do you think of the idea -- leaving aside for the moment the fact that the Americans have a group of people at the head, and the division of responsibility that that implies -- of permanent full time directors? There is the thought that this enables the central bank to take somebody out of a particular background and have him apply his efforts fully to central banking questions and problems.

MR. RASMINSKY: I know that this system is in force in the Bank of England where some people who we would regard as staff members are on the Board.

COMMISSIONER GIBSON: They will be taken in from other occupations --

MR. RASMINSKY: Yes, they may have been taken in for that particular purpose. I do not think that this essentially would add very much to our present system, if anything. What this does is to create a position of prestige. It provides an additional title that you can give to people who are working for the bank and who are associated with the directors, and who sit on the Court, as in the case of the Bank of England, and who, in discussions with the directors have the status of being colleagues on the Court of the Bank of England. The analogue in our case, is provided, I think, by the amendment to the Bank of Canada Act that was passed some years ago which enabled the Board to appoint one or more Deputy Governors in addition to the Deputy Governor whose appointment has to be confirmed by Order in Council, and who is presently Mr. Beattie.

I think that this is, in our system, essentially a matter of status, and I see no advantage in creating a new title in the Bank -- for example, that of Executive Director -- to give to one or two officials of the Bank who were also members of the Board.

COMMISSIONER GIBSON: You would not see it as a device for bringing in somebody from outside who was a fairly experienced senior person so that he may get into the Bank of Canada's operations?

MR. RASMINSKY: I think I would certainly

agree that from time to time it is desirable to bring in people from outside, and bring them in at quite senior levels. I do not think that the problems involved in that connection are problems that could be solved by changing a title -- by bringing a man in and calling him an executive director rather than bringing him in and calling him something else.

I would not want my replies to indicate a closed mind towards this, Mr. Gibson, but I do not see that it would really make a major change in the present arrangement.

I have been reminded of one aspect of the committee system that I did not touch upon, and which I think is worth saying something about. If you have a committee system where the decisions have to be taken in a formal way -- where monetary policy decisions have to be taken in a formal way, or decisions that affect the course of monetary policy -- then one effect of it, I am afraid, would be to delay the process of decision-taking. There was something said by Mr. Brown on Friday about the length of time that dealers sometimes feel it takes to get reactions from the Bank to offers or bids for securities. The process of monetary policy does have its day to day, or even hour to hour, aspects. This would be particularly the case if you were making some fairly major change -- if you were getting out of the market for a particular security altogether, for example -- and I say one effect of a more formalized process of decision-taking might well be to introduce more delay than we have now.

COMMISSIONER HARROLD: Following the same thought that Mr. Gibson has in mind of extending it to personnel at the management level, I believe the policy of the Bank now is to develop people from within the Bank; in other words, to bring in people from universities and to develop them. What would you think of the suggestion of having the Act provide that one of the Deputy Governors should come from a senior position in a chartered bank or other financial institutions outside? In other words, it would not be the responsibility of the Governor at an appropriate time to promote somebody from within the Bank, but that it be specified in the Act that this senior staff person should come from outside the Bank?

MR. RASMINSKY: Before I reply to that, Mr. Harrold, I would like to comment on something that you said in passing to the effect that it was the policy of the Bank to develop its staff from inside the organization. It certainly is the case that the policy of the Bank is to recruit as well as it can, to get as able people as it can, and to develop those people, and as they show themselves capable of assuming additional responsibility to give them additional responsibility. There is no policy in the Bank against recruiting at senior levels from outside the Bank, and, in fact, during the last two years there have been a couple of quite senior appointments made from outside the Bank, one of which has been announced within the last two weeks. We have recruited a man who was a partner in an investment house and he will be given

the special responsibility of maintaining our contacts and developing our contacts with the private capital market.

I would like to do more of this. I would like to make that clear. However, there are difficulties in connection with this. People of the type I have in mind, and who, I imagine, you have in mind in raising this question, people who have acquired a position of some considerable responsibility in their own firms and who are quite senior are, I think, in most cases, earning incomes which are higher than the Bank can pay. It is in only the fortunate case where there are other considerations in the mind of the individual and he does not care too much about that, or where the individual feels an interest and a challenge in coming into the central bank, or he has a feeling of public service, that we can do such recruting. I would like to do more. I think there is a danger in any organization in not from time to time introducing fresh blood and fresh attitudes from the outside. I want to say that because I do wish to make it clear that there is no policy against bringing people from outside into the Bank.

On the more specific question that you raised -- the question of a Deputy Governor being appointed from the chartered banks -- I would say that I have not seen that suggestion elaborated in any detail. I do not quite visualize how it would work. If what it means is that it would be desirable to get somebody who had recent commercial banking experience to give up a

career with the commercial banks and come to the Bank of Canada as a senior member of the staff -- perhaps as a Deputy Governor of the Bank of Canada -- I would certainly feel that that is a possibility I would welcome very much, and would be willing, and indeed, anxious to consider. I think that such a man, motivated by considerations that I would consider appropriate for him to want to throw in his lot with the Bank of Canada, could perform a very real service for us.

A difficulty there is the one that I have indicated, that people of the seniority that one has in mind for that are likely to be earning more money than they could be offered by the Bank of Canada. The suggestion may mean something else. It may mean that from time to time one or other of the chartered banks may be invited to second somebody to the Bank of Canada in the role of Deputy Governor with the thought in mind that he would do a stint of service in the central bank and then go back to his native habitat.

COMMISSIONER BROWN: Not back to the bank?

COMMISSIONER LEMAN: Back to the jungle.

MR. RASMINSKY: Or, shall we say, back to greener pastures. If that is what is meant by the suggestion then I see real difficulty in it because in the central bank those who are in a position of responsibility have access to information regarding the affairs of individual banks, and I would feel inhibited about, and I would see difficulty in, providing such information about the affairs of

competitors to a man who owed his primary loyalty to his own institution. I think that this would place the bank concerned in a position of such embarrassment that I doubt that this system would be one that would commend itself to the chartered banks.

THE CHAIRMAN: We shall adjourn for fifteen minutes.

--- A short recess.

MR. RASMINSKY: Mr. Chairman, I am sorry to say that I neglected at the opening this morning to introduce Mr. Mundy , the secretary of the Bank, who has been at the table with me today.

THE CHAIRMAN: Thank you. We will resume now. Mr. Harrold?

COMMISSIONER HARROLD: We were discussing the appointment of people from outside the Bank to positions at the management level in the Bank of Canada. I am sure you are familiar with the Federal Reserve Board system in which there is an exchange with some of the universities. The Federal Reserve Board is operating an exchange policy with respect to its research staff. It brings in people from the universities for two or three years on the understanding that the appointment is on a temporary basis. Have you considered something like this with respect to the Bank of Canada, or do you think it has any merit?

MR. RASMINSKY: I think that any arrangement

that would bring fresh minds and fresh ideas and attitudes into the Bank has merit. We do some of this during the summer, but we have not, to my knowledge, as I can recall at the moment, ever arranged to obtain the services of a university economist for a year or a longer period of time. Again, I certainly would not want to foreclose any possibility.

One of the difficulties, I suppose, is that it takes a fair amount of time before anybody you hire is of any use to you. You cannot bring in a man from a university for a year and give him the assignment of saying how the Bank should be run. He has to find out something about it first, and this takes some time. The assignments would have to be more specialized and confined to work in particular fields. Those fields would have to be supplementary to what the research staff of the Bank is already doing.

To answer your question directly, I have not in any concrete case considered an arrangement of the sort you suggest, but I think it is worth thinking about.

COMMISSIONER LEMAN: It might be good for the universities too?

MR. RASMINSKY: Yes. Of course, the university presidents will tell you that their need is greater than the need of the central bank; that there is such a shortage of qualified people, in view of the great growth of the university population, that they cannot spare their people. Many university economists, as I am sure you know, came here during the war. Several of them stayed for quite a time, and some are

still here, but some have returned. The universities have quite a problem in maintaining both the quantity and the quality of their instruction, and if one looks at the figures of the projections of university populations then it is evident that they are going to be faced with an increase in this problem.

COMMISSIONER HARROLD: I have one or two questions on the public relations of the Bank. There are various ways in which the Bank of Canada may conduct public relations: one is with the public generally; and another with the financial institutions which it affects. I believe in your evidence two or three days ago you mentioned speeches, plain English, as being a very good way to communicate with, shall we say, the chartered banks. Do you include in that speeches that might be made by the Governor or the Bank of Canada officials to the public generally?

MR. RASMINSKY: Yes, I do, Mr. Harrold. I think that in the ordinary course of events the central bank should try to explain what it is doing to people, that it should make information available on a wide basis -- not, of course, with the idea in mind of trying to persuade the public the Bank is necessarily right in everything that it does, but, rather, so that those who are interested in these matters can form their own judgments as to monetary policy and operations. Speeches are one technique of doing that.

Other techniques of conveying information to the public are the provision of statistical information, the provision of formal statements by the Bank -- such as, for example, the statement issued at the time of changes in the bank rate, the annual report of the Governor of the Bank. Apart from this, I think that the Governor and senior officers of the central bank should from time to time

make speeches to explain monetary policy, monetary operations.

The timing of such speeches raises some problems. I have felt, during the eighteen months of my governorship, that it was not appropriate or desirable for me to make public speeches, but that related to the circumstances of the time and does not by any means indicate a continuing attitude towards making speeches in public. Of course, so far as monetary policy, operations, are concerned, in the nature of things the speeches made by the Governor or the senior officers of the Bank have to be explanatory and, in a sense, backward looking, rather than constitute attempts to forecast the future, because if one were to make speeches of that sort it would run the risk of triggering off expectations, with disturbing effects on the markets. I think that the officers of the Bank must always be aware of this possibility when they speak in public.

COMMISSIONER HARROLD: That is all the questions I have, Mr. Chairman.

THE CHAIRMAN: I seem to recall that the Federal Reserve System directors go out and make speeches. Having come from certain regions of the country, they would make speeches within their own home boundaries, more or less, and the suggestion seemed to be that that was useful in keeping the people informed and in creating understanding of the operations of the system. Would that be practical, from the point of view of the Bank of Canada using

directors for making public statements of one kind or another?

MR. RASMINSKY: Certainly, there is no reason I can see why directors of the Bank of Canada should not make public speeches, if they feel they are able to and wish to. I do not know whether in the comparison you made you were referring to the governors of the Federal Reserve System or the directors of the Federal Reserve Bank.

THE CHAIRMAN: It may have been the directors of the Federal Reserve Bank.

MR. RASMINSKY: I am inclined to think that more speeches regarding monetary policy in the United States and the role of the Federal Reserve System are made by the governors of the Federal Reserve System than by the part-time directors of the various regional banks. In other words, they are made by individuals who are fully identified with, whose career is with the American central bank. Allowing for the differences in the constitutional or organizational setup, the analogy here would be speeches made not only by the Governor but by the Deputy Governor and other senior members of the staff. As I have indicated before, I would hope that we would be doing more of that. My own feeling of some inhibition about making public speeches over the last eighteen months has acted as a restraining influence on speech-making by other members of the staff of the Bank as well.

THE CHAIRMAN: In the preamble to the

act incorporating the Bank of Canada there is mention of some of what we now call the aims of monetary policy. It does not mention economic growth. Would it be of any value to revise to some extent that preamble, to spell out some of the objectives that we have been discussing and include economic growth, and possibly elaborate a little more on employment, which is thrown in in rather a minor way there?

MR. RASMINSKY: I think that the concept of economic growth is really implied in the preamble, where the purpose of the central bank is stated to be:

> "to regulate credit and currency in the best interests of the economic life of the nation, . . "

Presumably "the best interests" would embrace economic growth. I do not care to express a strong view, one way or the other, on that, Mr. Chairman. I do not think that the revision of this preamble would have any effect on the operations of the Bank of Canada because, as we made clear in our submission, we do regard these operations as being directed, in conjunction with other public economic policies, to the attainment of the objectives which the community wants, which we take to include economic growth and high levels of employment.

THE CHAIRMAN: We have had certain representations which indicate that some people, at any rate, place considerable importance on the preamble in this instance, and some sources we find

are more interested in spelling out economic growth and others are not interested in that so much as in spelling out the employment. For what it is worth, those views have been put to us, and I wonder whether there is any advantage in considering that sort of amendment.

MR. RASMINSKY: I think the main advantage would be that it would satisfy the views that have been expressed to you.

THE CHAIRMAN: I do not know whether it would satisfy them. It might assist, to some extent, but I was never quite sure myself as to what the value would be.

MR. RASMINSKY: I do not think it would have any real effect on the operations of the Bank, Mr. Chairman.

THE CHAIRMAN: I would hardly have thought it would have any effect on them, but it is just the question of whether, in the light of the experience that we have had since the Bank was established, the general aims and scope of its activities should be emphasized a little more for public consumption.

MR. RASMINSKY: I would say, Mr. Chairman, though this preamble is not drafted in the precise language that is currently in use, that I continue to regard this preamble as an excellent statement of the general objectives of the Bank.

THE CHAIRMAN: You have told us quite a bit about your activities as fiscal agent for the government. I do not know that there is anything

more I can at the moment ask you about your relations with the government on that level, except this: In so far as you act as fiscal agent, the government depends upon you for advice and, no doubt, generally follows it.

MR. RASMINSKY: There are two statements there, Mr. Chairman!

THE CHAIRMAN: Perhaps it should have been put as two questions instead of two statements.

MR. RASMINSKY: I am sorry -- have you put a question to me, Mr. Chairman?

THE CHAIRMAN: I will revise the position. As fiscal agent of the government you act in an agency position, merely, is that right?

MR. RASMINSKY: That is right, sir.

THE CHAIRMAN: It gives you no discretion as to policy?

MR. RASMINSKY: It gives us no authority to make decisions with regard to policy on matters that are the concern of the government.

THE CHAIRMAN: And when you advise the government, carrying out those functions, has the government ever rejected your advice?

MR. RASMINSKY: Mr. Chairman, I wonder whether, on consideration, you really wish to put that question?

THE CHAIRMAN: I wonder whether I can get at it in another way, without embarrassment. What I had in mind was that in your capacity as fiscal agent, and various functions that you perform

in that capacity, whether the government had any other source of advice?

MR. RASMINSKY: Yes, indeed, it has.

THE CHAIRMAN: Because I think I did ask a question along this line previously.

MR. RASMINSKY: Yes, indeed it has other sources, Mr. Chairman. With regard to financial matters the government has the advice of the officials of the Department of Finance, and the government has the advice of anyone who wishes to give advice to the government, or from whom the government invites advice. The government's contacts in the subject-matter in respect of which we act as fiscal agent are by no means limited to the Bank of Canada. The government -- either the Minister directly, or through his officials -- has contact with other interested parties. They have direct contact, for example, with investment dealers with regard to matters that they discuss with investment dealers -- the fiscal position of the government, the range of possibilities as regards new issues, as regards the way maturing issues should be handled. We have a responsibility to give advice in connection with these matters, but we are certainly not the sole source of advice to the government, and the government has no responsibility to follow our advice if the government prefers to follow some other course.

THE CHAIRMAN: I was just wondering to what extent, as a matter of practice and in fact, the government relied upon the Bank as fiscal agent for

the main source of direction -- whether in practice they in effect, exclusively relied upon the Bank in these matters. But your answer disposes of that question.

MR. RASMINSKY: Good.

THE CHAIRMAN: Then, in the operation of the government's deposit account and as adviser as to foreign exchange and matters of debt management, the situation is the same? You are advising in your capacity of fiscal agent and you also carry out the mechanics of the operation, whatever they may be? Is that about the situation?

MR. RASMINSKY: That is certainly true, or broadly that is true. The only distinction that I would make among the items that you have mentioned is this, that in respect of debt management and foreign exchange policy our role is definitely that of adviser.

THE CHAIRMAN: Yes.

MR. RASMINSKY: On the operation of the government's deposit account with us, we work on the basis of certain targets for the maintenance of the account with us. The significance of the distribution of the government's deposits as between us and the chartered banks is, of course, that this distribution affects the cash reserves position of the chartered banks.

But within these targets we work on, and within the general policies that are discussed with the Department of Finance, we are an operator and consequently have more initiative than we do with regard to the two broad questions of public debt management and foreign exchange policy.

THE CHAIRMAN: Then when we come to the question of monetary policy, the situation is different?

MR. RASMINSKY: Yes sir.

THE CHAIRMAN: In spite of the fact that the statute is silent as to who is responsible - that is so, is it not?

MR. RASMINSKY: That is right, sir.

THE CHAIRMAN: I did not think there was anything in the statute that settled that question, but it has generally, with a short exceptional period, been accepted that the Bank is responsible for monetary policy?

MR. RASMINSKY: I think, with the exception you referred to, it has been generally acknowledged that there is joint responsibility for monetary policy, that both the Bank and the government are responsible. The principle of joint or dual responsibility is the one that I put forward.

THE CHAIRMAN: I recall that. But when you speak of joint responsibility, how in practice does that work out? I recall you described how you are in constant touch with the Department of Finance with respect to monetary policy, but, generally speaking, is it not your discretion which determines whether

conditions should be tightened to some extent or otherwise?

MR. RASMINSKY: Subject to the ultimate responsibility of the government, that is right. The way it has worked out in practice in my case - and I speak only of my own experience - is that I have been responsible for the monetary policy of the Bank. All the monetary policy steps taken by the Bank have been initiated by me and conducted under my primary responsibility for the operations of the monetary policy. The government has been constantly informed of the developments in monetary policy, and the government has not dissociated itself from this policy; consequently, within the terms of dual relationship I would say that the system of joint responsibility for monetary policy has been the one that has been in practice here during my governership.

THE CHAIRMAN: Then, if the occasion arises when the government takes a different view from you, the government then would intervene and would intimate what that difference of view was? That is a hypothetical question, is it?

MR. RASMINSKY: It is a hypothetical question, but a very important one, Mr. Chairman.

There is constantly a process of discussion going on between the Bank and the government. When I say the "government", I refer to the various levels of government. The relations between the Bank and the officials of the Department of Finance are very close; we see a lot of them, and we are constantly discussing

the whole range of financial and economic developments, and they know what monetary policy is being pursued by the Bank and in the course of those discussions they have an opportunity to express views about the monetary policy.

In addition to discussions with the officials, I see the Minister of Finance regularly, and the same applies there. The Minister of Finance has the opportunity of expressing any views that he cares to express on monetary policy.

So, the principle which I stated in my statement of August 1, 1961, namely, that in the ordinary course of events the Bank has the responsibility for monetary policy, that principle has been carried out in practice.

The second principle - which, as you say, is a hypothetical one because the occasion has not arisen - is if the government disapproves of the monetary policy being carried out by the Bank, it has the right and the responsibility to direct the Bank as to the policy which the Bank shall carry out. That situation has not arisen; so, happilly, there is no practical experience that I can refer to as regards the technique by which this second principle would be made effective in practice.

THE CHAIRMAN: Do you think it would be advisable to recommend a statutory amendment to clarify that situation?

MR. RASMINSKY: Mr. Chairman, I think the essential thing in this respect is that we should be clear as to principles; that there should be no

misunderstanding on the part of any as to what are the principles that are operative with respect to the responsibility for monetary policy.

It would be for others to decide what the principle should be: I have stated my view of the principle, which is that the Bank should have primary responsibility for policy, that it obviously has responsibility for monetary operations, that ultimately if there is disagreement between the Bank and the government which, over a period of time, cannot be resolved by sincere effort to reach agreement through the process of discussion, the government must ultimately be in a position to assume responsibility. The central bank cannot be a state within a state, and hold out against carefully considered views of the government with regard to monetary policy.

THE CHAIRMAN: That appears to be recognized now. On the other hand, the statute does not deal with it, and there is always the possibility that some governor might decide that he is appointed for seven years and the responsibility is his, and that there is nothing in the statute to say that it is not his responsibility. It may be that Parliament would have something to say about it, but what is the power of the government, with the statutory position as it is, to intervene?

MR. RASMINSKY: I think that this is one of the most important questions, whether it is enough to rely on the general acceptance of these principles or to provide some mechanism which would ensure that the

Governor could not carry out a monetary policy of which the government disapproved, and that the government would at all times be in a position where it was clear under the legislation that it would indeed have final responsibility for monetary policy.

I thought it was right, as an attempt to assist the Commission in forming its own independent judgment on this, to put before you not only my August 1961 statement of general principles, but also to inform you that in my tenure as Governor the thing has operated according to these principles.

I think the essential thing here - and I don't mean this to be a comment on whether or not the legislation should be amended - is that there should be agreement, that there should be an understanding as to what the principles are, because no legislation that the wisest man could devise will guarantee proper operation of this relationship. I think that any legislation would be capable of being used for purposes that were not intended, unless there was in fact general agreement, as there seems to be, on what are the guiding principles.

THE CHAIRMAN: The difficulty appears to me to be that the Bank of Canada Act would indicate that the intention of Parliament was to set up an independent institution in the Bank of Canada, and now we have recognized the position which results in perhaps cutting down to some extent that original concept of independence.

I may be overstating the matter a bit by putting it that way, but for what reason would the Bank

be set up as an independent organization, with the separate statute, with its own powers, if it were that it could be interfered with from time to time by the government?

MR. RASMINSKY: With great respect, Mr. Chairman, I do not believe that the enunciation that I have made of these principles in any degree reduces the independence of the Bank below that which was originally intended by the legislature. In my judgment all it does is make explicit what I believe the implicit relationship between the Bank and the government has always been. I don't think it has ever been the case that the Bank could carry out a policy which was in conflict with the monetary policy desired by the government.

The question, it seems to me, is whether this situation which I think has always prevailed -- a situation which one of my predecessors, Mr. Towers, used to refer to as one in which the Bank could not hide behind the government and the government could not hide behind the Bank - whether that basic situation should be changed. In my judgment that situation has always been there and has always been what was intended. The question is whether a mechanism should be provided by which the government can, when it decides to do so, formally assume the ultimate responsibility for monetary policy which is in any case its responsibility.

If it does so, this, of course, does not relieve the Governor of his responsibility, because if the view of the government regarding the monetary policy to be followed is one which in conscious the

Governor is not able to share, then he has no possible alternative but to move off and make room for somebody who does share this view of the matter.

So, I would ask permission not to agree with the suggestion that the principles that I enunciated here subtract one iota from the degree of independence which the Bank had at any time.

On the other question which you raised -- why an independent central bank, why this degree of independence? I do not know whether the Governor of the Bank really should reply to this question. This is a decision of the legislature in the way that it set up the Bank. Most countries have found that the operations of the monetary policy can best be conducted in the public interest if conducted not by a branch of government but by an independent agency which is still of government but is not in government in the same degree as a branch of government.

As to the reasons why this has been found more satisfactory, I suppose that an independent agency is able perhaps to take a longer run view of monetary policy, and is not subject to the same pressures that might develop within government to be responsive to short run considerations. It means that the monetary manager has the independence of his own judgment as to what at that time the general interest requires; he has the independence to disagree with government, to try to pursuade government, and the independence ultimately to leave if he is not able to do so.

I think that the experience of other countries is that for these reasons it is more satisfactory to entrust this function to an agency which -- being part of the government apparatus -- has more independence, much more independence than it would have as a branch of government.

COMMISSIONER LEMAN: On the other hand, no country has gone so far as to put control of the Army under the monetary authority.

MR. RASMINSKY: No, and I hope they will not!

THE CHAIRMAN: I wonder whether this might have been in the minds of the Legislature, if it is possible to fathom that situation; after all, the independence of the Bank was provided for by Parliament, and might it not have been one of the reasons for providing for that independence that there would be a possibility from time to time of the Minister of Finance or the government of the day to take some hasty action or ill-advised action which would impair the position of the Bank of Canada, and for that reason no provision was made in that statute for interference by the government; that the independence of the Bank was one of the prime considerations that Parliament had in mind at the time that the Bank was set up. Might that not be putting it in the true perspective?

MR. RASMINSKY: I think that those considerations might well have played a part; the desire to have an institution which would not be responsive

to short-run political or partisan considerations in the policies that it pursued.

At the same time the position, of course, has always been that the Lord giveth and the Lord taketh away; blessed be the name of the Lord. It has always been open to government, if they are dissatisfied, to change the Act.

THE CHAIRMAN: Not the government, but Parliament.

MR. RASMINSKY: Yes, you are quite right.

THE CHAIRMAN: Parliament, which is quite a different thing; it would involve a very much broader discussion, the fact that government has power to act, it can act without any public discussion at all until after it is done, and it seems to me there is a very fundamental importance attached to the independence of the Bank and that anything that is done should be done in such a way that it will not impair that fundamental independence, because it seems to me that that was one of the essential purposes, unless it is desirable to abandon that purpose and put the Bank in the position of a department of government.

MR. RASMINSKY: No, I don't think that it is desirable to do that, Mr. Chairman, and I would certainly agree with you that nothing should be done that would impair the degree of the independence that the Bank has always had.

THE CHAIRMAN: Perhaps could we put it this way; that the Bank in its independence has, over

the years, recognized that there is, as you describe it, joint responsibility and that the Bank carries on in that way, but it has not abandoned the fundamental independence that was given it by the original statute.

MR. RASMINSKY: That is certainly the case so far as I am concerned, Mr. Chairman.

THE CHAIRMAN: It is rather a difficult situation, and one of the difficulties is to express in statutory language all the refinements that arise in consideration of this problem, but you do in your brief recommend a certain procedure to be followed.

MR. RASMINSKY: Well, what I have said in the brief, Mr. Chairman, is that first I am pleased that the Commission is going to exercise its own independent judgment with regard to this matter and to decide whether a new procedure is needed and, secondly, I have said that if the Commission should decide to recommend the procedure of a directive, a procedure under which the legislation would give the government the authority to issue a directive to the Bank as to the monetary policy which it wishes the Bank to follow, I have asked the Commission to consider carefully making sure that certain conditions should be fulfilled with regard to that directive.

These conditions are three: first of all that the directive should be formal, that the directive should be quite formal in character, which I have explained by saying that it would be in writing and would refer to the authority under which it was

issued and, second, that the directive should be specific in its terms and, third, that the directive should be published within a relatively short time.

THE CHAIRMAN: Would you add that the Governor should be entitled to explain his position if he disagreed with that of the directive?

MR. RASMINSKY: To explain it?

THE CHAIRMAN: In public.

MR. RASMINSKY: To whom?

THE CHAIRMAN: To the public.

MR. RASMINSKY: I think that the issue of such a directive, if it represented a conflict between the government and the Governor, that it would lead to public discussions and public explanations, and in that I would assume that the Governor would make his point of view known.

I don't think that it would be necessary for the legislation to make provision for that; it might be considered, however, whether the legislation should provide that in the event of the issue of a directive leading to a conflict -- I think it is to be considered whether the legislation should provide that the matter, the public statement made on the matter, should be referred to a parliamentary committee. I think that that would be the formal procedure which it would be necessary to provide, I suppose, in the legislation.

THE CHAIRMAN: Well, if a directive of that kind was issued and published, it would be pretty clear to the public that there had been a

disagreement between the Governor and the Bank, would it not?

MR. RASMINSKY: Mr. Chairman ----

THE CHAIRMAN: The government and the Bank.

MR. RASMINSKY: Yes, the government and the Bank. Having had no experience with a directive procedure, I would hesitate to be dogmatic as to what the issue of a directive would imply. My instinct in the matter is to feel that in most cases the issue of a directive is the final stage of an unsuccessful discussion; that it is likely to be a signing off, so to speak, and the bringing of a conflict out into the open where it becomes a matter of public discussion and on which public opinion can form.

I think that that is likely to be the way it would work out, but I would not like to take the position that this would be the only circumstances in which a directive might be issued. I think that it is possible to imagine situations where the government issued a directive that the Governor was prepared to accept without this giving rise to conflict.

It is even possible to imagine situations where the Governor might seek a directive from the government because, though he didn't think that the issue was one which warranted a conflict with government, but where he thought it none the less wise to focus responsibility where responsibility

lay, and thought that this could best be accomplished by the issue of a directive.

I think that it would be necessary in all these cases to make clear that the Governor would have the responsibility for making clear that the issue of a directive by the government -- in this latter type of case that I have referred to -- he would have to make clear that the issue of a directive by the government did not represent a conflict with him, in order to overcome what I think would be perhaps the normal expectation that this was a highly unusual procedure and must therefore represent a grave conflict between the government and the Governor.

THE CHAIRMAN: Well, there would be really two kinds of directives; one in the case of a fundamental conflict between the Governor and the government?

MR. RASMINSKY: Yes.

THE CHAIRMAN: And the other, if there was a conflict it was not a vital conflict, and the directive was in effect for clarification of the government's view, to protect the Governor if in future he was criticized for carrying out that view.

MR. RASMINSKY: Well, I would like to add this, that I don't think that that case relieves the Governor of responsibility; I don't think that the case, even on a relatively minor matter, I don't think that the moral responsibility of the Governor for carrying out a policy can be disengaged. I don't

think he has any way out of that; he must take responsibility for his actions even if a directive has been issued.

THE CHAIRMAN: I was wondering whether there might be some confusion in the public's mind as to these directives; if the public regarded a directive as being almost tantamount to a dismissal, and then a directive comes out and the Governor agrees to it, the public may think the Governor has weakened and it may reduce the prestige of the Governor.

MR. RASMINSKY: That is one of the reasons why it would seem to me -- and this, of course, is very hypothetical -- it would seem to me necessary, in case a directive were issued which the Governor did not regard as reason for leaving, it would seem to me necessary for the Governor to issue a statement to make clear the circumstances.

I think part of the difficutly in discussing this matter is not only that we have had no experience with directives, but notwithstanding the fact that the legislation of a good many central banks provides authority to the government to issue directives, it is very difficult to find any examples of cases where directives have been issued. The existence of the authority itself probably has the effect of facilitating the accommodation that is needed, and results in satisfactory outcomes of disagreements about monetary policy without the use of this directive.

THE CHAIRMAN: There might always be the

danger that the government might get into the habit of issuing directives.

MR. RASMINSKY: Pardon me, sir?

THE CHAIRMAN: There might always be the danger that the government might get into the habit of issuing directives; directives would become a common occurrence.

MR. RASMINSKY: This would be a danger; this is certainly a consideration to be taken into account.

THE CHAIRMAN: Then, there is the other possibility of a continuing directive setting forth a definition of the policy which the government settles upon to be carried out, perhaps for an indefinite period, until some change might take place. Have you considered that possibility at all?

MR. RASMINSKY: I don't think much of that, Mr. Chairman. It seems to me that a continuing directive of that sort which, presumably after process of discussion with the central bank, the government lays down the lines of policy to be carried out for a period of some time, I think that this suffers from two main defects, one of which is a good deal more important than the other.

One is that such a system, in my judgment, would constitute a major substraction from the independence of the central bank. The central bank would then seem to be nothing more than the agency for the conduct of the policy decided upon by the government.

Secondly, I think that such a directive could hardly meet one of the criterion which I refer to in my opening statement, namely, that the directive should be specific in its terms. I think it would be very difficult to formulate in specific terms a directive on the monetary policy that the government wished to have carried out over a period of time.

So, for these two reasons I would not be in favour of a continuing directive.

THE CHAIRMAN: Well, in the case of any directive would there not be considerable difficulty in being too specific? I find it rather difficult to visualize what the contents of a directive of this kind might be.

MR. RASMINSKY: Well, the directive might, for example, be to raise the bank rate. Perhaps I should say to reduce the bank rate! Or, the directive might be to alter the cash reserve requirements of the chartered banks, or it might be on the assumption that we were operating under some sort of a minimum liquid asset ratio system and the directive might be to change the ratio of the liquid assets that the banks were required to maintain. With somewhat less degree of specificity, it is possible to imagine a directive along the lines that the objective of the central bank should be to obtain or to carry out a policy which results in an increase or decrease of X or Y per cent in the money supply over a certain period of time, but

it seems to me for this procedure to operate at all satisfactorily that the directive has to be something more than to carry out the monetary policy that makes everybody happy.

THE CHAIRMAN: That is what I had in mind. Well, then, the other solution to this problem is to just leave it the way it is and rely upon the precedents that has been recognized, and all these matters can be worked out as they arise. I do not know whether you wish to express your views as to whether you would prefer that or something more formal.

MR. RASMINSKY: I would hesitate to express my view on that, Mr. Chairman, because I would not want to influence the Commission. This is a vital question on which I think the Commission should form its own independent judgment.

Of course, a difficulty in expressing a view is that one does not know how the directive system would actually work in practice. If it worked in the way you suggested before of directives being shot off every morning then it would not work. If it worked according to the broad principles which I have put forward then there is merit in having a situation which recognizes the ultimate responsibility of government in these matters; which recognizes that the central bank cannot carry out a policy which is profoundly at variance with the views of the elected representatives of the people. But, I come back to what I said before, that the important thing seems to me to be that the principles should be given some sort of sanction, but whether that sanction should take the form of an amendment to the act or whether the sanction should take the form - these principles have, of course, been accepted by the government -- of an endorsement of the formal

report is something on which I would not want to express a formal view.

COMMISSIONER GIBSON: I have one further question, Mr. Chairman. How far does the ultimate responsibility of the government for monetary policy involve the central bank in consulting with the Minister specifically prior to action being taken in the field of monetary policy? For instance, bank rate is one area of which I am thinking, and an important change in the banks' cash reserves is another, and so on.

MR. RASMINSKY: I think one has to distinguish here between the formal actions taken by the central bank and the developments in the monetary system that occur in the course of the Bank's cash managemement operations. As regards formal actions taken by the central bank such as the fixing of bank rate, and the changes in the bank rate, the Minister of Finance has been informed and consulted before those actions were taken.

The other matter, that of cash management, is a more gradual process. The changes that take place from day to day or from week to week in the cash position of chartered banks are not ordinarily very large, and there the regular meetings that I have with the Minister of Finance, in which the whole range of monetary and financial development is reviewed, provide an adequate opportunity for consultation.

COMMISSIONER GIBSON: Do you think if there were a formal directive system in existence that it would change the degree of prior consultation that you

have? To put it more specifically, would you feel in those circumstances, a desire to give a little more detail to the banks?

MR. RASMINSKY: No.

COMMISSIONER GIBSON: Thank you.

COMMISSIONER LEMAN: Mr. Rasminsky, let us use a specific example of the type of thing that might or might not lead to a directive. Under the fixed bank rate system which you have adopted suppose you are considering changing it and you inform the Minister that it is your intention to change it, and the Minister says that he does not like the proposed change. In those circumstances would you feel, for instance, that you should be able to go on and change it anyway, or would you say, if you felt strongly enough about it, "You had better tell me specifically why you do not like it; why you want the bank rate to stay where it is"?

MR. RASMINSKY: That is a hypothetical question, Mr. Leman, and I do not think that I could really give a truly responsive answer to it without knowing what the circumstances of the time are. The case for acts of monetary policy, and for the timing of acts of monetary policy, are, in my experience, not always completely clear cut. One can never be certain in one's own mind that one has the ultimate truth that one knows precisely that the change in bank rate, for example, should be of given magnitude and that it should be taken at a given time.

Consequently, in the ordinary course if one discusses these matters one would not discuss them with

a completely closed mind, or with one's mind made up. On the other hand, there might well be circumstances in which the Governor of the Bank feels certain that he knows what should be done and when it should be done, and if in those circumstances he found that the Minister of Finance strongly held a different view he would certainly expect, not only in those circumstances but in all circumstances, the Minister of Finance to state his reasons for holding the view that he holds, and if after prolonged discussion of the matter the two views were not brought together and could not be reconciled then I think the Governor would say to the Minister: "Well, if that is the way you feel about it I have to ask you to take the formal responsibility for registering your view and issue a directive".

It might be that the need to take that responsibility of issuing the directive, with the inherent possibility of conflicting publicity, and so on, would be an additional consideration that the Minister of Finance would wish to take into account, and which he has not previously taken into account.

COMMISSIONER LEMAN: I am really groping for occassions when a directive would be useful that would not lead to the resignation of the Governor. That is the only point on which I am a little ---

MR. RASMINSKY: It is difficult to think in specific terms of these things, of which we have had no experience. The only point I wanted to register before is that I did not want to express a dogmatic view that the only time that a directive would be issued

would be just prior to the resignation of the Governor.

THE CHAIRMAN: There are some other matters that are, perhaps, of less importance than this one that I wish to mention. Section 14 of the Act provides for the Governor's veto. Has that ever been exercised?

MR. RASMINSKY: No, sir, it has not.

THE CHAIRMAN: Is that a section of the Act that has some value?

MR. RASMINSKY: I have not found it to be of any value.

THE CHAIRMAN: Are there any conceivable contingencies that might arise that would make its remaining there useful?

MR. RASMINSKY: I do not know what the real legislative history of that section is. It was apparently designed to ensure that if there was an important conflict between the Governor and the Board of Directors that this would come to the attention of the government and that the government would decide. That provision, incidentally, is evidence from the Act itself that the government under the present Act has powers with regard to the administration of the Bank and the conduct of the Bank's affairs. The power has not been exercised, and I do not know that I would regard it as a very useful and vital power, with the directors carrying out the functions that I discussed before.

THE CHAIRMAN: Exactly, yes.

MR. RASMINSKY: If the directors made certain decisions with regard to the conduct of monetary

policy which were forward looking rather than their having this general responsibility of being satisfied with the monetary policy and with the way the Bank was being run that I referred to before, then the veto power would, I think, be a useful power because, as I have indicated, I think the responsibility of the Bank in relation to the government and in relation to public opinion must be focussed in the person of the Governor. But, as the Bank operates I do not see any particular value in the veto power.

COMMISSIONER LEMAN: I am wondering if it would follow from what you have just said that the retention of the power of veto is a sort of notice to the Board of Directors that it should not meddle in monetary policy.

MR. RASMINSKY: I do not think so, Mr. Leman.

THE CHAIRMAN: The next point I wish to ask about in reference to the Act is with respect to the gold reserve and the redemption requirements. I am referring to section 23 (1) :

> "The Bank shall maintain a reserve against its outstanding notes and deposit liabilities consisting of its holdings of gold coin and bullion ..."

That is somewhat of an anachronism now, is it not?

MR. RASMINSKY: I think I would say it is otiose.

THE CHAIRMAN: So you would have no objection if that were repealed?

MR. RASMINSKY: No, I would not, Mr. Chairman.

THE CHAIRMAN: Then there is the provision as to the Bank of Canada's being the fiscal agent for provinces. That has never been acted upon. Is there any point in retaining that power?

MR. RASMINSKY: I think the only point of retaining it would be not to make an amendment that is of no particular significance. As you say, the power has never been acted upon. The provision does not require the Bank to accept that responsibility.

THE CHAIRMAN: Would you go so far as to suggest that it is not of the sort of power that would be appropriate for the central bank to exercise?

MR. RASMINSKY: I find it very difficult, Mr. Chairman, to imagine circumstances in which it would be appropriate for the central bank to assume the responsibility of acting as a fiscal agent for a province.

THE CHAIRMAN: In section 18 of the Act the Bank is given certain powers to deal in a variety of instruments and make certain investments. Do you consider that the authority given in this section is sufficiently wide under present conditions? Are there any additions to those powers that might be appropriate?

MR. RASMINSKY: As regards the instruments in which we can deal?

THE CHAIRMAN: Yes.

MR. RASMINSKY: No, sir. In my experience the powers provided under this section for our operations have been adequate. I am not aware of any defficiency in these powers, and I have no additions to these powers that I wish to suggest.

COMMISSIONER LEMAN: Mr. Rasminsky, I have another question. Do you feel that there would be some merit in the Act clarifying somewhat what the powers of the Bank should be in the realm of the ownership of real estate ? There seems to be a little bit of equivocal language used in the Act now.

MR. RASMINSKY: The language used in the Act in this regard, Mr. Leman, is the same as the language used in certain other Acts; in particular, the same as the language used in the Bank Act. Section 18 (n) of our Act gives the Bank the power to:

> "acquire by purchase or lease and hold real or immovable property for the actual use and occupation of the Bank in connection with its business and sell and dispose of the same;"

Section 81(1) of the Bank Act reads:

"The Bank may acquire and hold real and immovable property for its actual use and occupation and the management of its business, and may sell or dispose of the same, and acquire other property in its stead for the same purpose."

So that our powers in this respect are identical with the powers of the chartered banks. The Bank has taken the advice of counsel with regard to any real estate operations in which we have been engaged, and we are satisfied that all those operations, actual and potential, are fully within the ambit of our powers under the Bank of Canada Act, so we do not feel the need for any clarification of those powers.

COMMISSIONER LEMAN: Could something be done in the Act that could serve as clarification, at least in the minds of the public, as to how far it can expect the Bank to go or not to go in the ownership of real estate?

MR. RASMINSKY: If Parliament wished to incorporate into the Bank of Canada Act any encouragements or injunctions in that respect it would, of course, be open to Parliament to do so, but we have nothing to propose in that regard.

COMMISSIONER LEMAN: Could we ask you what the policy of the Bank really is in this field? Is it cost minimization, or what is it? Would the Bank consider operations in real estate as a money-making proposition?

MR. RASMINSKY: No, sir. The policy of the Bank in this respect is to provide facilities that are appropriate and necessary to conduct the Bank's operations. As you are aware, the Bank has agencies across Canada. The Bank's requirements in respect of real estate are rather unusual requirements. In particular, the Bank has to have a great deal of underground vault space for the storage of valuables, currency and securities; and this not only in the main financial centres, but across the country where emergency stocks of currency may be kept, and in order to put the Bank in a position where the Bank is, in a case of an emergency, able to conduct its operations from a variety of centres. This means that buildings which are constructed for the purpose of the Bank involve an expense in building which would not be undertaken by a private builder, since this expense of this large vault space is special to the Bank's requirements. In consequence of this fact, the Bank has constructed its own buildings to meet its own requirements in a number of places.

When the Bank constructs a building, or considers constructing a building, it takes into account a variety of considerations, one of which is the need to be located conveniently to its customers, conveniently to those with whom it has business transactions and, in particular, the banks and investment dealers. This, in turn, means that the Bank is located, or tends or wishes to be located to carry out its functions properly, in what you might describe as down-town locations close to the financial district.

Unfortunately, such locations tend to be rather expensive, so that the real estate that the Bank requires for this tends, on the whole, to be rather high-priced real estate.

When the Bank puts up a building it has in mind the need to put up a building which is large enough to look after not only its immediate requirements but also its projected future requirements. This, not only for the Bank of Canada but also for our subsidiary, the Industrial Development Bank. The Bank also has to have in mind the economic use of the land that it has acquired; and in many cases the Bank would be making uneconomic use of the land if it put up a building which was small in relation to the value of that land.

The combination of these factors that enter into our consideration of the matter has meant that in some cases the Bank has constructed buildings which, in the first place and for some little time ahead, provided space to rent to others. In renting the space to others the Bank is guided by the prevailing rates for similar space in the areas concerned, and does not undercut the market.

COMMISSIONER LEMAN: I have one question on another subject that we talked about this morning. You have explained to us that at times you have regular and formal meetings with representatives of the chartered banks. I believe the trust companies and even the loan companies have expressed an opinion that it might be useful to them if the Bank sometimes held formal meetings with their representatives, to give them

the Bank's views on the way they may fit their operations into the particular, desired credit conditions that the Bank has in mind. Can you see any difficulty about this, springing from the fact they do not belong to the system formally, as such?

MR. RASMINSKY: Not at all. I would be delighted to meet with any group that is willing to meet with me.

THE CHAIRMAN: There are just three small points that I overlooked. Section 11 of the Bank of Canada Act, as amended, provides for the directors' fees to be fixed by the bylaws of the Bank. The aggregate amount shall not exceed $30,000 in any year. That is the aggregate amount covering the fees of all the directors, as I understand. Is that sufficient now?

MR. RASMINSKY: I would like to see that limit increased, Mr. Chairman, at the time that the Act is revised. The limit has not been an inhibition on the frequency of meetings that the directors have thought appropriate, but it is a pretty snug fit, and if the directors should decide that they wish to meet more frequently than seven or eight times a year, then the $30,000 limit would be inadequate. I would like to see the limit raised.

THE CHAIRMAN: Then the next point is with respect to the length of term of office of the Governor and the directors. Is that satisfactory as it stands?

COMMISSIONER LEMAN: Or would twenty-five years be better?!

MR. RASMINSKY: I thought that question was of the opposite character -- whether three or four years would be better!

I would see no reason for proposing a change in the time, or for resisting anybody's proposal for a change in the length of the term.

THE CHAIRMAN: It has also been suggested that there should be a regular parliamentary review of the operations of the Bank -- that is, by a parliamentary committee.

MR. RASMINSKY: Well, parliament, I take it, is master of its own procedure, Mr. Chairman, and if Parliament wishes to consider, let us say, the annual report of the Bank, or to call the Governor to appear before it, it is open to Parliament to do so.

COMMISSIONER BROWN: In both the Bank Act and the Quebec Savings Bank Act there is a section which includes a government guarantee on the chartered banks' deposits and the Quebec Savings Bank deposits in the Bank of Canada. If this is going to be in the statute anywhere, it would seem more appropriate that it should be in your act. I wondered if you had any comments on that peculiarity.

MR. RASMINSKY: No, I am afraid I do not know enough about it to comment, Mr. Brown.

COMMISSIONER BROWN: I think it is section 71(3) of the Bank Act.

COMMISSIONER LEMAN: Perhaps it should be put on the record that the guarantee has never been invoked!

MR. RASMINSKY: I am really shocked as I read this provision. There is provision for the various cash reserves to be maintained with the Bank of Canada, and then section 71 (3) of the Bank Act reads:

> "If the property and assets of the Bank of Canada are insufficient to pay its debt and liabilities" --

I am not going to read the rest of it! I think I would agree that if such a provision should be found anywhere, perhaps it would be better in the Bank of Canada Act.

COMMISSIONER BROWN: There is a similar subsection in the Quebec Savings Bank Act.

THE CHAIRMAN: That concludes the discussion.

I should like to say that we wish, once again, to thank you, Mr. Rasminsky, and your staff for all the help that you have given to this Commission both before and during these hearings. I should like to make particular reference to the truly magnificent performance that we have had from yourself, Mr. Rasminsky, during the last four days.

We shall now adjourn until 9:15 tomorrow morning, when we shall consider the submission of the Canadian Bankers' Association.

MR. RASMINSKY: Thank you very much, Mr. Chairman.

--- Adjourned.

SUBMISSION BY

THE BANK OF CANADA

TO

THE ROYAL COMMISSION ON BANKING AND FINANCE

BANK OF CANADA, Ottawa.

May 31, 1962.

The Hon. Dana Porter,
Chairman,
Royal Commission on Banking and Finance,
Toronto.

Dear Sir:

I have the honour to provide herewith the following submissions of the Bank of Canada to the Royal Commission on Banking and Finance:

Submission	I:	The Constitution and Functions of the Bank of Canada
Submission	II:	The Role of Monetary Policy
Submission	III:	The Techniques of Monetary Policy
Submission	IV:	The Role of the Bank of Canada in Debt Management
Submission	V:	The Role of the Bank of Canada in Foreign Exchange.

Yours very truly,

L. Rasminsky,

Governor

Submission by the Bank of Canada to the Royal Commission on Banking and Finance

May 31, 1962.

I - THE CONSTITUTION AND FUNCTIONS OF THE BANK OF CANADA

Ownership

1. The Bank was founded in 1934 as a privately-owned corporation. By 1938 ownership had passed in two stages to the Government of Canada and since that time the Minister of Finance has held the entire $5 million share capital issued by the Bank. The Bank of Canada Act provides that, except for such amounts as may be required (under a formula laid down in the Act) to build up the Rest Fund gradually to $25 million, the annual profits of the Bank are to be remitted to the Receiver General of Canada for credit to the Consolidated Revenue Fund. The Rest Fund limit was reached in 1956 and since then all of the profits have gone to the Receiver General.

Management

2. The responsibility for the affairs of the Bank of Canada rests with a Board of Directors composed of the Governor, the Deputy Governor and twelve Directors. The Directors are appointed for three year terms by the Minister of Finance with the approval of the Governor in Council. They must be selected from diversified occupations, and no Director can be a director, officer or shareholder of a chartered bank. The Directors, in turn, appoint the Governor and Deputy Governor, also with the approval of the Governor in

Council, for seven-year terms during good behaviour. The Governor, the Deputy Governor and the Directors are eligible for reappointment on the expiration of their terms of office. In the transaction of the business of the Bank each Director has one vote. The Deputy Minister of Finance sits on the Board but does not have the right to vote. The Board normally meets eight times a year. Between its meetings an Executive Committee, composed of the Governor, the Deputy Governor, one Director and the Deputy Minister of Finance (without a vote), acts for the Board and has all the powers of the Board. It is required to submit its minutes to the next Board meeting. It is specified by By-Law that the Executive Committee shall meet at least once every week and in practice any Director who is in Ottawa on the day of the meeting attends.

3. The presence of the Deputy Minister of Finance on both the Board of Directors and the Executive Committee provides a formal channel of communication between the Bank of Canada and the Department of Finance. It is supplemented by many other closer contacts of a less formal character.

4. The Governor is Chairman of the Board and chief executive officer of the Bank and handles the direction and control of the Bank's affairs on behalf of the Board. The Governor has the power to veto any decision of the Board or its Executive Committee but must inform the Minister of Finance of his action within seven days, and the Governor in Council may confirm or disallow the veto. Any Director may also inform the

Minister of his view of the matter in question and this must also be transmitted to the Governor in Council. There has been no occasion on which the Governor has exercised his right of veto.

5. In the absence of the Governor, the Deputy Governor exercises all the powers of the office.

6. The salaries of the Governor and Deputy Governor, who are full-time officers of the Bank, are determined by the Directors subject to the approval of the Governor in Council. The other Directors are not paid salaries: they are entitled to receive fees for attendance at meetings of the Board and the Executive Committee which, exclusive of expenses, cannot exceed $30,000 per year for the Board as a whole.

7. In addition to the Deputy Governor who is a member of the Board of Directors, there may be one or more Deputy Governors appointed by the Board to perform such duties as are assigned to them. At the present time there are two Deputy Governors so appointed by the Board.

Monetary Policy Function

8. The duties of the Bank are stated in a very general way in the preamble to the Act, which indicates that the Bank is to "regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote

the economic and financial welfare of the Dominion". The Act does not specify the methods by which the Bank should pursue its objectives but certain powers that it grants to the Bank, together with certain provisions of other legislation, enable the Bank to influence credit conditions in the economy.

9. The Bank of Canada Act gives the Bank the sole right to issue notes payable to bearer on demand intended for circulation in Canada, and the Currency, Mint and Exchange Fund Act provides the Bank of Canada notes are legal tender and, except for gold coin, and subsidiary coin in very small amounts, the only form of legal tender in Canada. (The Bank of Canada Act provides that Bank of Canada notes shall be redeemable in gold, and that it shall maintain a gold reserve of at least 25 per cent against its outstanding notes and deposit liabilities. The gold redemption requirement has been suspended each year since 1934 by order-in-council under section 22 of the Bank of Canada Act. The gold reserve requirement was withdrawn in 1940 by the Exchange Fund Order and this withdrawal was continued by subsequent legislation -- since 1952 by the Currency, Mint and Exchange Fund Act -- subject to reimposition by order-in-council).

10. The Bank Act requires that each chartered bank maintain on the average during each calendar month cash reserves in the form of Bank of Canada notes and deposits at the Bank of Canada equal to at least 8 per cent of its Canadian dollar deposit liabilities. The Bank of Canada Act permits the Bank to buy and sell a

nomic and financial welfare of the Dominion".

The Act does not specify the methods by which the Bank should pursue its objectives but certain powers that it grants to the Bank, together with certain [illegible] of other legislation, enable the Bank to influence [illegible] [illegible]ons in the economy.

9. The Bank of Canada Act gives the Bank the [illegible] right to issue notes payable to bearer on demand intended for circulation in Canada, and the Currency, Mint and Exchange Fund Act provides the Bank of Canada notes are legal tender and, except for gold coin, and subsidiary coin in very small amounts, the only [illegible] legal tender in Canada. (The Bank of Canada Act [illegible] that Bank of Canada notes shall be redeemable in gold [illegible] that it shall maintain a gold reserve of at least 25 per cent against its outstanding notes and deposit liabilities. The gold redemption requirement has been suspended each year since 1934 by order-in-council [illegible] section 22 of the Bank of Canada Act. The [illegible] reserve requirement was withdrawn in 1940 by [illegible] [illegible] Order and this withdrawal was continued by subsequent legislation -- since 1952 by the [illegible] Mint and Exchange Fund Act -- subject to reimposition by [illegible]

10. The Bank Act requires that each [illegible] [illegible] on the average during each [illegible] [illegible] reserves in the form of Bank of Canada notes [illegible] [illegible] at the Bank of Canada equal to at least [illegible] [illegible] the Canadian dollar deposit liabilities. The [illegible] Canada Act permits the Bank to vary [illegible]

broad range of financial assets. These provisions enable the Bank to vary the amount of cash reserves available to the banking system and by so doing to regulate the broad trend of the combined total of currency outside banks and chartered bank deposit liabilities in a manner consistent with the changes in credit conditions which it considers appropriate in all the circumstances.

11. The Bank of Canada may buy and sell Government of Canada securities (including guaranteed issues), provincial securities, bills of exchange and bankers' acceptances, foreign exchange, securities of the United States and short-term securities of the United Kingdom. The Bank may also acquire securities issued by its subsidiary, the Industrial Development Bank, as provided in the Industrial Development Bank Act. In practice, purchases and sales of financial assets undertaken for the purpose of influencing monetary and credit conditions have been conducted almost exclusively in Government of Canada securities.

12. The Bank may make short-term advances to chartered banks or to banks which operate under the Quebec Savings Bank Act on the pledge or hypothecation of a wide range of financial assets. The Bank may also make short-term advances to the Government of Canada. The minimum rate at which the Bank is prepared to make advances is called the Bank Rate and the Bank of Canada Act requires that it shall be made public at all times. The Bank also enters into purchase and resale agreements with money market dealers.

[illegible] al assets. These provisions [illegible] vary the amount of cash reserves [illegible]

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13. The Bank has the power to alter the minimum cash reserve ratio of the chartered banks between 8 per cent and 12 per cent provided that it gives notice of at least one month before any change is made and provided that it does not increase the ratio by more than one percentage point in any one month. This power, which was granted to the Bank at the time of the 1954 revision of the Bank of Canada Act, has not been used to date.

Fiscal Agency Functions

14. The Bank of Canada Act requires the Bank to act as fiscal agent for the Government of Canada without charge. In this capacity it operates the Government's deposit account through which flow virtually all Government receipts and expenditures, handles debt management and foreign exchange transactions for the Government, and acts as an adviser. In respect of debt management, the Bank looks after the arrangements for the sale of new Government security issues and all the work connected with the outstanding public debt, including the maintenance of records, interest payments and redemption of Government securities at maturity date; the Bank, however, acts only as fiscal agent and the responsibility for debt management policy rests with the Government. The Bank handles the foreign exchange business of the Government including the transactions of the Exchange Fund account which it carries out on the instructions of the Minister of Finance; the responsibility for policy in this respect rests with the government.

[illegible] Bank but the [illegible] to after the [illegible]

[illegible]

[illegible] notice of at least one month before any change is made [illegible] provided that it does not increase the [illegible] by more than one percentage point in any one month. This [illegible], which was granted to the Bank at the time of the 1954 revision of the Bank of Canada Act, has not been [illegible] [illegible] to date.

[illegible]

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Other Functions

15. In addition to the accounts of the Government of Canada and the chartered banks, the Bank of Canada operates deposit accounts for the banks which operate under the terms of the Quebec Saving's Bank Act, and for foreign central banks and the international financial institutions. The Government of Canada maintains foreign currency balances with the Bank of Canada and in this connection and in order to facilitate foreign exchange arrangements the Bank of Canada carries foreign currency accounts with foreign central banks. The Bank of Canada does not accept deposits from the general public.

16. The Bank is empowered to accept deposits from and make short-term loans to any provincial government. By agreement with a province the Bank may act as its banker and fiscal agent. No arrangements of this nature have been made.

17. Canadian coin is made and issued by the Royal Canadian Mint but the Bank of Canada arranges for shipment to the main branches of the chartered banks.

Internal Organization

18. Of the Bank's total staff of 800 about three-quarters are engaged in the servicing of the currency and the public debt and in its banking functions. The Securities and Foreign Departments carry out the Bank's open market operations and its work on behalf of the Government in connection with debt management and foreign exchange operations; they provide the Bank with its constant contact with financial markets and have a

[illegible] [illegible] [illegible] [illegible] in addition to the accounts of [illegible] Government of Canada and the chartered banks, the Bank of Canada [illegible] [illegible] [illegible] [illegible]ates deposit accounts for the banks which operate under the terms of the Quebec Savings Bank Act, and for foreign central banks and the international financial institutions. The Government of Canada [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] Canada are in that connection and in order to facilitate foreign exchange arrangements the Bank of Canada accepts [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]. The Bank of Canada does not accept deposits from [illegible] [illegible] [illegible].

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[illegible]

18. Of the Bank's total staff of [illegible] [illegible] [illegible] are engaged in the [illegible] of [illegible] currency and [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] the Securities and Foreign Exchange [illegible] [illegible] the [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]

[illegible]

[illegible] [illegible] [illegible] [illegible] [illegible]

[illegible] [illegible] [illegible] [illegible]

staff of about 50. In the Research Department about 70 employees are engaged in compiling, analyzing and interpreting economic and financial information for the use of the management. Actual numbers in each section of the Bank, including its nine regional agencies, as at January 1, 1962, are shown below:

Bank of Canada Staff at January 1, 1962
(excl. Building Maintenance Personnel)

	Total	Of which - Men	Women
Governors and Executive Assistants	6	6	-
Research Department	72	25	47
Securities Department	36	23	13
Foreign Exchange Department	13	7	6
Audit Department	28	6	22
Chief Accountant's Department	10	9	1
Currency Division	59	14	45
Public Debt Division	239	27	212
Secretary's Department	114	43	71
Regional Agencies	221	99	122
	798	259	539

Reporting

19. The Act provides that within two months after the end of the financial year the Bank shall transmit to the Minister of Finance a statement of its accounts and an Annual Report by the Governor covering such matters as he may deem desirable or as the Minister

may require. It also provides for publication of the Bank's statement of its assets and liabilities as at each Wednesday and each month-end. In addition the Bank issues each Thursday a Weekly Financial Statistics release covering the more liquid assets of the chartered banks as of the day before, and all their major asset and liability items as of eight days before. Each month the Bank publishes a Statistical Summary which is chiefly directed towards financial data but includes also most of the major series of economic statistics.

Submission by the Bank of Canada to the Royal Commission on Banking and Finance

May 31, 1962.

II. THE ROLE OF MONETARY POLICY

May 31, 1962

II. THE ROLE OF MONETARY POLICY

(The text of a statement on this subject by the Governor of the Bank of Canada issued on August 1, 1961 is appended to this submission).

A. The Objectives and Scope of Monetary Policy

1. The broad objectives of monetary policy are those of public economic policy generally. Monetary policy operates as one important element in the totality of national policies, both financial and non-financial, which are directed towards broad national economic goals. The preamble to the Bank of Canada Act describes the functions of the Bank as being "to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit (Since 1939 the direct responsibility for Canada's foreign exchange policy has, under various Acts of Parliament, been vested in the Government of Canada. In its monetary management the Bank must, of course, take account at all times of Canada's balance of international payments and the need to maintain a sound external financial position.) and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion". In Canada the standards for "the economic and financial welfare" of the nation are rightly set high and may be said to include: sustained economic growth at high levels of employment and efficiency, internal price stability and the

11. The Role of the Bank of Canada

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Monetary policy and other national policies

The broad objectives of monetary policy are those of public economic policy generally. Monetary policy operates as one important element in the [illegible] of national policies, both financial and [illegible].

The preamble to the Bank of Canada Act describes the functions of the Bank as being "to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit [illegible] Since 1939 the [illegible] responsibility for Canada's foreign exchange [illegible] under various Acts of Parliament, been [illegible] Government of Canada. In [illegible] management the Bank must, of course, take account of all [illegible] [illegible] a balance of international payments [illegible] to maintain a sound external financial position [illegible] to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion". [illegible] [illegible] for "the economic and financial [illegible] which are rightly set high and may be [illegible] sustained economic growth at high levels [illegible]

maintenance of a sound external financial position, an equitable sharing of economic benefits and burdens and the maintenance of a high degree of economic freedom.

2. Good progress toward the nation's economic goals depends on a wide range of factors, many of which are beyond the direct and immediate control of public policy. This is particularly true of a country such as Canada, on which external economic developments are bound to have a major impact and in which private enterprise has traditionally played a major role. Developments in the outside world determine the environment in which Canadians must sell their exports and compete with imports, and these developments are often of critical importance to Canada which is so heavily dependent on foreign trade and foreign investment. Much also depends on the enterprise of management, the skill and self-discipline of the whole population, and the natural resources, capital equipment and productive techniques available. The possibility of maintaining a satisfactory rate of growth in employment and putput, given the shifting demands and preferences of final consumers in Canada and abroad and the degree of competition from foreign suppliers, also depends very much on the degree to which labour, management, and plant capacity can shift from declining products into new lines of work (perhaps in new locations) for which markets are expanding. In addition, the efficient performance of our economy depends to a considerable extent on the responsiveness and competitiveness of the markets for goods, services and finance and on the

appropriateness of the various regulations and practices affecting particular industries and groups which have come to be regarded as part of the ground rules of the system. For the various reasons enumerated in this paragraph public economic policies, though always important, are by no means always the dominant influence on economic developments.

3. Modern economics are so complex that in the present state of economic knowledge it is difficult to diagnose with precision the causes of unsatisfactory economic performance or to prescribe with confidence effective remedial measures, let alone to bring them into force. Public economic policy (including monetary policy) must therefore to some extent feel its way along on the basis of imperfect knowledge. Moreover, it is always subject to limits imposed by public understanding and acceptance of what it is seeking to achieve and of the means which it employs.

4. A prime task of public economic policy is to influence the changing level and pattern of over-all demand for goods and services in a manner which is appropriate to the economic circumstances, including particularly the degree of utilization of the nation's productive capacity and labour supply, the degree of pressure on price levels, and the state of its balance of international payments. To take the simplest case, the emergency of substantial unemployment together with idle plant capacity and a much reduced level of imports would point to the desirability of measures which would temporarily at any rate stimulate demand. On the other

hand, in a situation which combined strong upward pressure on prices and costs, a tight labour market and a sharply rising level of imports there clearly would be need for measures designed to impose some temporary restraint on the growth in demand. In practice, of course, the indicators of the direction which policy should take may be ambiguous; and even where there is no doubt about the appropriate direction, decisions about the exact measures to use will always be difficult.

5. So far as monetary policy is concerned the central bank must over the years satisfy the need of a growing economy for a larger stock of money, and in the course of doing so it can, over shorter periods, help to moderate undesirable swings in the level of over-all demand. The financial policies of the Government will also have an important influence on the level of over-all demand. Indeed, fiscal measures (affecting among other things the balance between Government receipts and outlays), debt management measures (affecting the maturity distribution and other aspects of the structure of Government debt) and central bank operations may be regarded to some extent as alternative methods of influencing demand and the level of activity. For example, the economic situation might be characterized by strongly rising pressure of demand involving a serious risk of inflation. If the public policies adopted to deal with this situation included strong fiscal measures designed to exercise restraint on demand, the need for a monetary policy that accepted relatively high interest rates would be much less than if fiscal restraint were

need, [illegible]

[illegible] on prices and costs, a tight labour market and a sharply rising level of imports there clearly would be need for measures designed to impose a very heavy restraint on the growth in demand. In practice, of course, the indicators of the direction which policy should take may be ambiguous; and even where there is no doubt about the appropriate direction, decisions as to the exact measures to use will always be difficult.

5. So far as monetary policy is concerned the central bank must over the years satisfy the needs of a growing economy for a larger stock of money, and in the course of doing so it can, over quite short periods, help to dampen down undesirable swings in the level of overall demand. The financial policies of the government will also have an important influence on the level of demand [illegible] changes the balance between government receipts and [illegible], and [illegible] the distribution and [illegible] of the structure of government debt) and central bank operations [illegible] regarded to some extent as alternative policies in influencing demand and the level of activity. For example, the present situation might be [illegible] strongly rising pressure of demand implying a [illegible] risk of inflation. If the public policies [illegible] to deal with this situation included strongly fiscal measures designed to exercise restraint on demand, [illegible] monetary policy that accepted relatively [illegible] [illegible] could be much less than if fiscal [illegible]

not exercised vigorously.

6. There will, however, be differences in the way in which different combinations of public policies aimed at the same general objectives work out their effects on the economy. The choice of policies depends upon the results that are sought and the speed with which they are sought in the particular circumstances. For example, different combinations of policy measures will have different effects on the country's external financial position, and over a period of time there is a choice of measures that can be taken to accommodate the requirements of external financial balance. A country's deficit or surplus on international transactions in goods and services must, of course, be matched by a net inflow or outflow on capital account or by changes in official reserves. Within limits, foreign exchange reserves can play an important part in cushioning distrubances in the external balance, but subject to this, external financial balance is dependent upon appropriate domestic policies. Among these, the degree of emphasis on monetary policy can vary in accordance with the nature and timing of changes in other policies. Because of its flexibility monetary policy can be used, for example, to try to achieve a relationship between interest rates in internal and external markets which is consistent with the flow of capital needed in the circumstances while changes in other policies are being made with a view to altering the underlying balance of payments situation.

7. The choice among various combinations of

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7. The choice among [illegible]

policy measures always involves difficult judgments as to which combination will in fact best serve to promote the community's objectives. At any given moment, of course, the choice is influenced by institutional arrangements such as the practice of annual budgeting. The fact that taxation and Government expenditure programmes tend to be fixed for a year ahead means that they cannot quickly be adapted to the changing requirements of the current economic situation, whereas monetary policy (and to some extent debt management policy) are much more flexible. It is worth noting here that several countries have recently taken steps looking towards more flexibility in rates of taxation as a means of influencing economic conditions.

8. As indicated above, there is considerable scope for varying the way in which fiscal, debt management, and monetary policies are combined, and it may very well be desirable at times to alter the "mix" by relying more heavily on some of these policies than on others to achieve the desired goals. The need for a consciously co-ordinated blending of policies has been recognized by many observers. The Governor of the Bank in a public statement issued on August 1, 1961 referred to "the need for a careful and consistent meshing together of all the various aspects of financial policy and general economic policy in the effort to attain... (these) objectives while avoiding undue strains in particular sectors. In particular, since monetary policy, fiscal policy and debt management policy are interdependent and to some extent inter-changeable, there

[illegible]

[illegible]

[illegible] At any given moment, of [illegible] is influenced by institutional arrangements such as the practice of annual budgeting. The fact that taxation and Government expenditure programmes tend to be fixed for a fairly short period means that they cannot quickly be adapted to the changing requirements of the current economic situation, whereas monetary policy (and to some extent debt management policy) are much more flexible. It is worth noting here that [illegible] towards more flexibility in rates of taxation as a means of influencing economic conditions.

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has to be a high degree of co-ordination to ensure that the blend or 'mix' of these policies is purposefully directed towards attaining the over-all economic objectives of the community."

9. One of the important functions performed by the central bank is to influence the decisions which determine the 'mix' of policies in the financial and economic field. The central bank is not endowed with superior wisdom in these matters but it is charged by statute with important responsibilities and must make its own judgments regarding the degree of central bank action and the net balance of other policy measures which seem appropriate in the circumstances. It can and should make its point of view known to the Government. The central bank will bring to such discussions certain special expertise resulting from the closeness of its operational contacts with financial markets. Its influence will depend in part on the quality of its economic and financial information and analysis and on the standing it enjoys in the Government and in the community generally. It is clearly of great importance that there should be close and continuous consultation between the Government and the central bank at all times if the central bank is to exert an appropriate influence in developing and maintaining suitable and properly co-ordinated monetary, fiscal and debt management policies.

10. The central bank can and should express its views on these matters to the Government, on occasion even to the point of private "nagging". But in the

final analysis it must take the Government's expenditure, taxation, and debt management policies as given (even though it may be trying in private to persuade the Government to change one or more of these policies) and must follow the monetary policy which, in these circumstances and having regard to the over-all economic situation, seems the most appropriate. Its field of choice may be greatly restricted by the other policies being followed, since the central bank cannot base its own policy on objectives that differ in a major way from those on which other public financial policies are based, but it may on occasion have to be influenced by its view of the speed with which the latter will be adapted to the changing requirements of the over-all economic situation. Clearly monetary policy cannot be formulated or judged in isolation but only in the context of the continuing appropriateness of the total "mix" of policies to the circumstances and problems of the time.

B. The Influence of Credit Conditions on the Demand for Goods and Services.

11. The operations of the Bank of Canada exert their influence on the level of demand for goods and services through their effects on credit conditions. By credit conditions is meant the whole range of terms and conditions affecting borrowing and lending and the purchase and sale of financial assets: the level and structure of securities prices and yields, institutional lending and deposit rates, and the various requirements (over and above the payment of a certain rate of interest) which lenders require of borrowers as a condition of making funds available, e.g. the specifications of standards of credit-worthiness, collateral security, repayment period, etc. Credit conditions are also affected by many factors other than Bank of Canada operations, but before discussing these, it may be useful to consider in a general way how credit conditions influence the level of spending on goods and services.

12. If business firms, individuals or governments are to increase their rate of spending in relation to income, they must be willing and able to finance the additional expenditure involved. This will entail either additional borrowing, or disposing of financial assets already owned, or foregoing the accumulation of financial assets which would otherwise have taken place out of current income. Each of these methods of financing involves an impairment of the spender's financial position compared with what it might otherwise have been. Every spender must continually

weigh the attractions and advantages involved in financing it, given the circumstances prevailing at the time. The extent to which spenders are willing and able to go on stepping up their rate of spending relative to their incomes, i.e. in pressing their demands for goods and services at the expense of their financial positions, will clearly be influenced to some degree by the conditions, both current and prospective, which confront them in financial markets. Relevant considerations include the current and prospective availability and cost of credit, the current and prospective interest or dividend return available on financial assets of various kinds, the current and prospective prices at which securities can be bought or sold and the associated risk of capital loss or chance of capital gain. Other things being equal, the more difficult, expensive or risky it becomes to borrow (and the more attractive it becomes to acquire or hold financial assets) the greater will be the restraining influence of credit conditions on the demand for goods and services. On the other hand the easier, cheaper or less risky it becomes to borrow (and the less attractive it becomes to acquire or hold financial assets) the more stimulating will be the influence of credit conditions on the demand for goods and services.

13. A tightening or easing of credit conditions is likely to be reflected in the availability of credit as well as in the effective interest yields obtainable on financial assets of various kinds. Rising interest rates and falling securities prices generally tend to be

weigh the attractions and advantages involved in financing it, given the circumstances prevailing at the time. The extent to which spenders are willing and able to go on stepping up their rate of spending relative to their incomes, i.e. in pressing their demands for goods and services at the expense of their financial positions, will clearly be influenced to some degree by the conditions, both current and prospective, which confront them in financial markets. Relevant considerations include the current and prospective availability and cost of credit, the size of any prospective interest or dividend return available on financial assets of various kinds, the current and prospective prices at which securities can be bought or sold and the associated risk of capital loss or chance of capital gain. Other things being equal, the more difficult, expensive or risky it becomes to borrow (and the more attractive it becomes to acquire or hold financial assets) the greater will be the restraining influence of credit conditions on the demand for goods and services. On the other hand the easier, cheaper or less risky it becomes to borrow (and the less attractive it becomes to acquire or hold financial assets) the more stimulating will be the influence of credit conditions on the demand for goods and services.

13. A tightening or easing of credit conditions is likely to be reflected in the availability of credit as well as in the effective interest yields on financial assets of various kinds. Rising interest rates and falling securities prices

associated with a stiffening of the non-price terms and conditions of new loan contracts; conversely, a decline in the cost of borrowing is likely to be accompanied by an easing of other credit terms as lenders are induced by the desire to remain fully invested to be less selective in the credit risks which they accept.

14. Considerations of availability may often be more important to a borrower than interest rate considerations because of the practices followed by lenders and the imperfections of financial markets. For example, some financial institutions may be subject to legal ceilings on the rates of interest that they can charge and when these ceilings have been reached they may have no choice but to ration credit in other ways. In some areas of the financial market interest rates, even though not subject to legal ceilings, may be sticky and this may temporarily at any rate produce a similar result. Other lenders, at some level of interest rates, may impose a limit on themselves rather than risk public criticism of higher rates. If there is not a sufficient diversification of lending channels some borrowers who cannot obtain credit from their normal sources may find that credit is not available from other sources even though they would be willing to pay relatively high interest rates.

15. In certain cases the supply of funds available at going rates of interest is restricted by the unwillingness of financial institutions to incur the losses involved in selling securities at a relatively low price even in order to acquire higher-yielding assets.

associated with a stiffening of the [illegible] conditions of new loan commitments. Consequently, a rise in the cost of borrowing is likely to be accompanied by a rationing of other credit to the [illegible] the desire to remain fully invested to the [illegible] in the credit terms which they accept.

14. Considerations of availability [illegible], often be more important to a borrower than interest rate considerations because of the practices followed by lenders and the imperfections of financial markets. For example, some financial institutions are subject to legal ceilings on the rates of interest they can charge and when these ceilings are reached they may have no choice but to ration credit to customers. In some areas of the financial markets [illegible] even though not subject to legal ceilings [illegible] and this may temporarily [illegible] result. Other lenders, at some level of [illegible] may impose a limit on their [illegible] of higher rates. [illegible] diversification of lending [illegible] cannot obtain credit from their [illegible] that credit is not available from other [illegible] though they would be willing to pay relatively high interest rates.

15. In certain cases the supply of funds [illegible] available at going rates of interest is [illegible] the unwillingness of financial institutions [illegible] losses involved in selling securities [illegible]

Such losses would tend to lower the earnings shown for the current financial year or, if this could be avoided by charging them to contingency reserves, they might reduce those reserves to an unacceptable level. In this case the reduction in the availability of funds arises from the nature of conventional accounting practices.

16. The flow of funds from investors to borrowers may on occasion be strongly affected if the market comes to feel that current market levels of interest rates are inappropriate. If investors are convinced that the level of rates is too low they may delay making investments. If borrowers feel the level is too high they may put off borrowing as long as they can. The flow of new issues in the capital market may be brought to a virtual standstill if the consensus of either investors or borrowers is that they can do better by waiting.

17. In general, the fewer the rigidities and imperfections in financial markets the more are credit conditions mainly a matter of the cost of money. The more widespread the rigidities and imperfections the more important become considerations of availability.

18. The effect of changes in the cost and availability of credit is of course not the same for everyone. Some kinds of spenders and some kinds of spending are probably relatively little affected; for example, many consumers seem quite insensitive to changes in rates of interest charged on their borrowings and rates of return available on the investment of their

e current financial year or, if [illegible]

by charging them to contingency reserve [illegible]

before these reserves [illegible]

this case the reduction in the availability [illegible]

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delay making investments. If borrowers [illegible]

as too high they may put off borrowing [illegible]

can. The flow of new issues in the capital market [illegible]

brought to a virtual standstill [illegible]

investors or borrowers [illegible]

17. In general, [illegible]

imperfections in financial [illegible]

[illegible] mainly a matter of [illegible]

more [illegible] the [illegible]

more important before consideration of [illegible]

[illegible] The effect of [illegible]

[illegible] ability of credit is [illegible]

everyone. Some kinds of [illegible]

[illegible] many consumers [illegible]

[illegible] in terms of interest charged [illegible]

[illegible] rates of return available [illegible]

savings. Small changes in interest rates may have a negligible effect on the investment spending of business firms in cases where cost of capital is a minor element in total costs, or where repayment periods are relatively short and anticipated rates of return are relatively high. In other cases credit conditions may be given much more weight. Investment spending in industries employing large amounts of capital in relation to annual turnover and operating on relatively low profit margins seems particularly likely to be sensitive to changes in interest rates. Some borrowers have a wide variety of alternative sources of funds to turn to if their full credit demands should happen to be scaled down or refused by the lending institution on which they normally rely, but others who do not have such alternatives open to them are much more sensitive to changes in credit conditions.

19. In general, it would appear that most spending plans are probably open to marginal trimming or enlargement and, within limits, to postponement or acceleration depending upon financial conditions. Where there is some doubt as to whether or not to proceed, or how far or how fast to proceed, it may not take more than a minor change in credit conditions to resolve the doubts one way or the other. While small changes in credit conditions may have only a small impact on the level of demand for goods and services, it is also no doubt the case that large changes in credit conditions have a large impact on demand.

20. The exact strength of the influence of changes in credit conditions on spending decisions at any

ations. Small changes in interest rates may have a [illegible] effect on the investment spending of [illegible] lines in which the cost of capital is a minor [illegible] [illegible] of costs, or where prospective profits are relatively large and anticipated rates of return are relatively high. In other cases credit conditions may be given much more weight. Investment spending in industries employing large amounts of capital in relation to annual turnover and operating on relatively low profit margins seems particularly likely to be sensitive to changes in interest rates. Some borrowers have a wide variety of alternative sources of funds to which to turn if their credit demands should happen to be cut down or refused by the lending institutions with which they normally deal, and others, who do not have such alternatives open to them, are much more sensitive to changes in credit conditions.

10. In general, it would appear that [illegible] terms are probably often of marginal importance, [illegible] etc., within limits, in postponement of [illegible] or lengthening over financial conditions. There there is some doubt as to whether or not to proceed [illegible] it may not take [illegible] [illegible] credit conditions to [illegible] [illegible]. While [illegible]

[illegible]

particular moment in time cannot be known with certainty either in advance or in retrospect, and the evidence that is available is subject to differing interpretations. An important reason for this is that spending decisions are also influenced by an enormously wide range of other factors. Business spending plans are often appreciably changed, for example, by the discovery of new production techniques, the availability of new machinery and equipment, the discovery of new natural resources, changes in the cost of materials and labour and in taxation arrangements and, more generally, by changes in the levels of current or expected business profits. Similarly, consumer spending plans are frequently changed by the appearance on the market of new or different goods and services, by changes in tastes and customs, and by changes in the actual or expected levels of personal income. These various influences give rise to continuous and sometimes sharp changes in the trend of total spending.

[illegible] in time cannot be known,

in advance or in retrospect, and the evidence

that is available is subject to differing interpretations.

An important reason for this is that spending decisions

are also influenced by an enormously wide range of

other factors. Business spending plans are often

significantly changed, for example, by the discovery of new

production techniques, the availability of new machinery

and equipment, the discovery of new natural resources,

changes in the cost of materials and labor, and in

[illegible]

in the levels of current or expected sales and profits.

Similarly, consumer spending plans are frequently

changed by the appearance on the market of new or

different products and services, by changes in tastes and

fashions, and by changes in the actual or expected level

of personal income. These various influences give

rise to variations and more [illegible] in the

trend of total spending.

C. The Main Factors Affecting Credit Conditions

21. The succeeding sections of this submission are devoted to discussion of the nature and extent of the central bank's ability to influence credit conditions and of the considerations relevant to the appropriate use of that ability. But this must not be taken to imply that the central bank's operations are the only important dynamic force at work. The factors which bring about changes in the community's desire to save (In this submission the term "saving" is used to mean the net accumulation of financial assets.) and to spend and in the degree of liquidity it wishes to maintain in its holdings of financial assets constitute basic underlying forces influencing credit conditions at all times. Monetary policy operates in the context of these underlying forces and in conjunction with the influence exerted by Government fiscal and debt management policies. The task of the central bank is to assess the nature and impact of all these factors and to decide whether in the circumstances it should allow them to be fully reflected in credit conditions, or whether and to what extent it should attempt to reinforce or mitigate their effect. Its decisions must, of course, at all times take into account and be influenced by balance of payments considerations and the need for the whole mix of policies to contribute to a sound external financial position.

22. Any substantial change in the demand for goods and services (or, to put it another way, in the desire to save) will of itself affect interest rates and credit availability. If the members of the community

The [illegible] Factors [illegible]

[illegible]. [illegible] of the [illegible] of [illegible]

[illegible] of the [illegible]

[illegible]'s ability to influence [illegible]

[illegible]. The conditions [illegible] to the [illegible]

of that ability. For this must not [illegible]

that the central bank's operations are the only [illegible]

dynamic force at work. The [illegible] bring about

changes in the community's desire to save (In this

submission the term "saving" is used to mean [illegible]

accumulation of financial assets) and to spend and in

the degree of liquidity [illegible] in [illegible]

holdings of financial assets [illegible]

forces [illegible] work [illegible]

Monetary policy [illegible] of [illegible]

[illegible] forces and in [illegible] the [illegible]

[illegible] by Government [illegible]

The task of the [illegible]

[illegible] of all these forces and [illegible]

[illegible]. It should [illegible]

[illegible] conditions, [illegible]

should attempt to [illegible]

Its decisions must, of [illegible]

[illegible] and be influenced [illegible]

considerations and [illegible]

to contribute to a sound [illegible]

[illegible] Any [illegible]

goods and services [illegible]

desire to save) [illegible]

[illegible] liquidity [illegible]

attempt on balance to step up substantially their rates of spending, the supply of securities and loan obligations offered in financial markets tends to increase relative to the demand for them, with resulting upward pressure on interest rates and perhaps reduced credit availability. To the extent that these spending plans are actually carried out, money incomes will rise and because of this fact people will want to hold among other things larger money balances on the average than they did previously. The increase in holdings of money will be desired in part to accommodate the increased volume of payments to be made, although this is by no means the only motive for holding money and the amounts actually held greatly exceed the minimum required for transactions purposes. (For this reason, the relationship between the level of income and the size of money balances held i.e. the income velocity of circulation of money, can vary widely). The attempt to acquire and maintain larger money balances will also put pressure on credit conditions unless offset by other factors. Conversely, attempts to reduce rates of spending on goods and services will tend to ease credit conditions.

23. In the preceding section of this submission reasons were given for believing that credit conditions can themselves be an important factor influencing the trend of total spending on goods and services. At the same time, the trend of total spending is (as indicated in the immediately preceding paragraph) an important factor influencing credit conditions. There is thus inter-action between the

[illegible]rs. In Illinois, [illegible] began to increase rapidly

[illegible] the demand for money, [illegible]

[illegible] interest rates and perhaps [illegible]

the extent that these [illegible]

carried out; money balances [illegible]

that people will want to hold [illegible]

money balances [illegible] than they [illegible]

The increase in [illegible]

part to [illegible] the increased [illegible]

[illegible]

[illegible] and the [illegible] actually [illegible]

[illegible] the minimum [illegible]

For this reason [illegible]

[illegible]

[illegible] variety of [illegible]

[illegible]

[illegible]

[illegible] to reduce [illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]. There is [illegible]

level of spending and credit conditions. Attempts to increase spending relative to income will tend to bring about some tightening of credit conditions, and the tightening of credit conditions will tend to feed back and moderate the growth in spending plans. Conversely a decline in the desire to spend will tend to ease credit conditions which will feed back to moderate the decline in spending plans. This inter-action between spending and credit conditions is stabilizing in character in that it limits the amplitude of fluctuations in the rate of total spending that would otherwise occur and helps to prevent them from becoming cumulative. In this sense it is a "built-in" regulator of the level of economic activity, but it must be recognized that at any particular point in time the stability achieved by undue reliance on this mechanism might be at a level of economic activity which was inconsistent with the broad economic objectives of the community.

24. Interest rates and credit availability may be affected, sometimes quite powerfully, by changes in the form in which members of the community want to hold financial assets and owe debt. There are many different kinds of financial assets for people to hold, and one of the ways in which they differ widely is in terms of what is usually called their liquidity. At the liquid end of the spectrum is money itself, which can be used to buy goods and services or other financial assets at any time without any intermediate step and with no risk of loss of capital value measured in money terms. Other financial assets involve a larger element of risk

[illegible] spending relative to income will tend to bring [illegible] some tightening of credit conditions, and the tightening of credit conditions will tend to feed back and moderate the growth in spending plans. Conversely a decline in the desire to spend will tend to ease credit conditions which will feed back to moderate the decline in spending plans. This inter-action between spending and credit conditions is a stabilizing influence in that it limits the amplitude of fluctuations in the rate of total spending that would otherwise occur and helps to prevent them from becoming cumulative. In this sense it is a "built-in" regulator of the level of economic activity, but it must be recognized that at any particular point in time the stability achieved by some reliance on this mechanism might be at a level of economic activity which was inconsistent with the broad economic objectives of the community.

14. Interest rates and credit availability may be affected, sometimes quite powerfully, by changes in the form in which members of the community wish to hold financial assets and owe debt. There are many different kinds of financial assets [illegible] and one of the ways in which they differ from one another is in terms of what is commonly called their liquidity. At one [illegible] end of the spectrum is money itself, which can be used to pay goods and services or other financial assets at any time without any inconvenience or cost and at no risk of loss of capital value [illegible] financial assets involve [illegible]

to the holder because their conversion into money at some future date may involve difficulties or capital losses which cannot be foreseen. These other kinds of financial assets are less liquid than money in varying degrees, depending among other things on their term to maturity, the extent to which they are traded in organized markets and the credit standing of the debtor. Short-term assets, for example treasury bills or commercial paper, approach money in their liquidity in that they are usually readily convertible into money with little or no loss of capital value. Other types of financial claims such as long-term securities involve a much larger element of uncertainty; their conversion into money prior to maturity may involve a substantial capital loss or gain, and may in some cases be difficult or perhaps even impossible. Since most people are averse to risk and uncertainty, they will not normally hold these less liquid assets in preference to more liquid assets unless they receive a larger return. The public's aversion to risk and the degree of uncertainty about the future may vary from time to time, however, and the size of the "risk premium" for holding longer-term assets will vary correspondingly.

25. Shifts are continuously occurring in people's preferences as to the degree of liquidity which they desire in their financial asset holdings and their debts and these shifts have important effects on credit conditions. If, for example, a substantial number of people come to regard their holdings of money as being higher than they would like to see in relation to their

to one to that because their conversion into money in the future date may involve difficulties or losses which cannot be foreseen. These other forms of financial assets are less liquid than money in varying degrees, depending among other things on their term to maturity, the extent to which they are traded in organized markets and the credit standing of the issuer. Short-term assets, for example treasury bills or commercial paper, approach money in their liquidity in that they are usually readily convertible into money with little or no loss of capital value. Other types of financial assets such as long-term securities involve a much larger element of uncertainty; their conversion into money prior to maturity may involve a substantial capital loss or gain and may in some cases be difficult or perhaps even impossible. Since most people are averse to risk and uncertainty, they will not normally hold these less liquid assets in preference to more liquid assets unless they receive a larger return. The public's aversion to risk and the degree of uncertainty about the future vary from time to time, however, and the size of the "risk premium" for holding longer-term assets may vary correspondingly.

(b) Shifts are continuously occurring in people's preferences as to the degree of liquidity they may desire in their financial asset holdings from time to time, and these shifts have important effects on the economy. If, for example, a substantial number of people come to regard their holdings of money as too large, larger than they would like to have relative to other

holdings of marketable bonds they will attempt to use part of their money holdings to purchase bonds and in the process the prices of bonds will be bid up and interest rates will decline. Conversely, a strong feeling that the proportion of financial assets being held in the form of marketable bonds is too high may lead to an attempt on the part of the community to increase its money holdings by selling bonds and this will cause the prices of bonds to decline and interest rates to rise. The actual situation is likely to be a good deal more complex than these examples would indicate. There are in fact continuous shifts in preferences through the whole range of financial assets -- money, close substitutes for money, other short-term financial assets and longer-term financial assets -- and they affect the relative levels of short-term and long-term rates and the general level of interest rates. Such shifts may take place as a result of changing assessments of the economic outlook, or changing expectations regarding future trends in interest rates, security prices, credit availability and the purchasing power of money. To mention only one example, if a tightening of credit conditions, including a rise in interest rates, comes to be regarded as probable, a widespread tendency may emerge for investors to shift out of longer-term, higher-yielding assets into more liquid assets which offer greater protection against capital loss; this in itself will tend to bring about a rise in long-term interest rates. Liquidity preferences are always changing, usually only slowly, but sometimes quite rapidly, and

holdings of marketable bonds they will attempt to [illegible]

[illegible]

the process the prices of bonds will be bid up and interest rates will decline. Conversely, a strong feeling that the proportion of financial assets being held in the form of marketable bonds is too high may lead to an attempt on the part of the community to increase its money holdings by selling bonds and this will cause the prices of bonds to decline and interest rates to rise. The actual situation is likely to be a great deal more complex than these examples would indicate. There are in fact continuous shifts in preferences through the whole range of financial assets -- money, close substitutes for money, other short-term financial assets and longer-term financial assets -- and they affect the relative levels of short-term and long-term rates and the general level of interest rates. Such shifts may take place as a result of changing assessments of the economic outlook, or changing expectations regarding future trends in interest rates, security prices, the availability and the purchasing power of money. To mention only one example, if a tightening of credit conditions, including a rise in interest rates, comes to be regarded as probable, a widespread tendency may develop for investors to shift out of long-term, higher yielding assets into more liquid assets which offer greater protection against capital loss, but this in turn will tend to bring about a rise in long-term interest

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usually only slowly, but sometimes quite rapidly, and

their accommodation involves continuous adjustments in security prices and yields and in the type of financial assets available to investors. The ease or difficulty with which this accommodation can be achieved depends in part on the operations of banks and other financial intermediareies because they can alter the mix of financial assets available to investors. This process is described later in paragraphs 56 and 57.

26. The effect of changes in liquidity preferences on credit conditions has been described in terms of shifts that people try to make in the composition of their holdings of financial assets, but it is also the case that debtors can exert an influence on credit conditions by attempting to change the composition of their debt.

27. The Government's borrowing operations arising out of fiscal policy and debt management have an impact on credit conditions similar in kind to comparable operations by other debtors but they are usually so large in size as to be in themselves an influence important enough to merit special mention. Changes in the amounts of money which the Government raises through the sale of its securities (if it is in over-all deficit) or uses for debt retirement (if it is in over-all surplus) affect credit conditions through changing the total demand for credit in the economy. Changes in the maturity distribution of the Government debt affect credit conditions by changing the maturity distribution of the public's holdings of financial assets.

28. This section of the submission has

[illegible]

security prices and yields and in the type of financial assets available to investors. The ease or difficulty with which this accomplishment can be achieved depends in part on the operations of banks and other financial intermediaries because they can alter the mix of financial assets available to investors. This process is described later in paragraphs 56 and 57.

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27. [illegible] arising out of fiscal policy and debt management have an impact on credit conditions similar in kind to comparable operations by other debtors but they are usually so large in size as to be in themselves an influence important enough to merit special mention. Changes in the amounts of money which the Government raises through the sale of its securities (in order to cover its deficits) or uses for debt retirement (out of its budget surpluses) affect credit conditions through altering the total demand for credit in the economy. Changes in the maturity distribution of the Government's debt affect credit conditions by changing the maturity distribution of the public's holdings of financial assets.

28. With the retention of the necessary [illegible]

referred to the way in which credit conditions are affected by changes in the community's desire to save and to spend and by changes in the community's liquidity preferences and has drawn attention to the importance of fiscal policy and debt management policy in affecting credit conditions. The next section outlines the way in which the central bank exercises an independent influence on credit conditions; this is introduced by a brief description of the role of cash reserves in the financial system.

D. The Central Bank and the Credit System

The Role of Cash Reserves in the Financial System

29. The central bank is the ultimate source of cash in the financial system. The Bank of Canada acquires financial assets -- in practice chiefly Government securities -- in exchange for its own obligations, namely Bank of Canada notes and deposit liabilities. The obligations of the Bank legally constitute the ultimate means of settlement in Canada; they do not have to be redeemed, nor need any reserve be held against them. (The Bank of Canada Act provides that Bank of Canada notes shall be redeemable in gold and that a gold reserve of at least 25 per cent shall be maintained against the Bank's outstanding note and deposit liabilities. The gold redemption requirement has been suspended each year since 1934 by order-in-council under section 22 of the Bank of Canada Act. The gold reserve requirement was withdrawn in 1940 by the Exchange Fund Order and this withdrawal was continued by subsequent legislation -- since 1952 by the Currency, Mint and Exchange Fund Act -- subject to reimposition by order-in-council). Bank of Canada notes are legal tender -- that is, they must by law be accepted in final settlement of debts -- and Bank of Canada deposit liabilities are accorded the same status in practice, since they are convertible into legal tender on demand, constitute legal cash reserves for the chartered banks, and serve as the medium for inter-bank settlements. So far as the public and the banks are concerned, the usefulness of Bank of Canada notes and deposits lies in

[illegible]

[illegible]

(b) [illegible]

[illegible]

[illegible] (1) The [illegible] of cash in the financial system. The Bank of Canada acquires financial assets -- in practice chiefly Government securities -- in exchange for its own obligations, namely Bank of Canada notes and deposit liabilities. The obligations of the bank legally constitute the ultimate means of settlement in Canada; they do not have to be redeemed, nor need any reserve be held against them. (The Bank of Canada Act provided that Bank of Canada notes shall be redeemable in gold and that a gold reserve of at least 25 per cent shall be maintained against the Bank's outstanding note and deposit liabilities. The gold redemption requirement has been suspended each year since 19[illegible] by order-in-council under section 22 of the Bank of Canada Act. The gold reserve requirement was withdrawn in 1940 by the Exchange Fund Order and this withdrawal was confirmed by subsequent legislation -- since 1952 by the Currency, Mint and Exchange Fund Act -- subject to reimposition by order-in-council). Bank of Canada notes are legal tender -- that is, they must by law be accepted in the settlement of debts -- and Bank of Canada deposit liabilities are regarded the same [illegible], since they are convertible into legal tender on demand; [illegible] constitute legal cash reserves of the chartered banks and serve as the medium for interbank settlements. [illegible]

[illegible] as the public and the banks are concerned, the [illegible] of Bank of Canada notes and deposit liabilities [illegible]

the fact that,even though they do not bear interest and are not redeemable, they can always be exahanged for other financial assets or for goods or services, and their value in terms of the national monetary unit does not fluctuate. Subject to its overriding responsibility for conducting its operations in such a way as to promote the nation's economic welfare the Bank can, by varying the prices at which it is willing to buy or sell Government securities or other assets, determine the amount of its own liabilities (Bank of Canada notes and deposits) held by others.

30. The chartered banks also issue obligations, namely deposit liabilities, which are generally acceptable as means of payment in Canada, although they do not have the status of legal tender. These deposit liabilities are a form of book debt, in most cases subject in practice to transfer by cheque; such cheque payments provide the means of settlement for the great bulk of transactions in Canada. Banks are able to persuade the public to regard their deposit liabilities as the equivalent of legal tender by undertaking to convert them into legal tender on demand. (Or, in the case of time deposits, on some specified date in the near future). In order to leave no doubt as to its ability to do so, each bank whether or not required to do so by law must maintain at all times substantial reserves of cash and liquid assets to meet net withdrawals of currency or net settlements due to other banks arising out of the transactions of its customers. However, the size of these reserves does not need to be

the fact that, even though they do not bear interest and are not redeemable, they can always be exchanged for other financial assets or for goods or services, and their value in terms of the national monetary unit does not fluctuate. Subject to its overriding responsibility for conducting its operations in such a way as to promote the nation's economic welfare the Bank can, by varying the prices at which it is willing to buy or sell Government securities or other assets, determine the amount of its own liabilities (Bank of Canada notes and deposits) held by others.

30. The chartered banks also issue obligations — demand deposits — which are generally acceptable as means of payment in Canada, although they do not have the status of legal tender. These deposit liabilities are a form of book debt, in most cases subject in practice to transfer by cheque; such cheque payments provide the means of settlement for the great bulk of transactions in Canada. Banks are able to persuade the public to regard their deposit liabilities as the equivalent of legal tender by undertaking to convert them into legal tender on demand (or, in the case of time deposits, at some specified date in the near future). In order to leave no doubt as to their ability to do so, each bank whether or not required to do so by law must maintain at all times adequate reserves of cash and liquid assets to meet any likely demands for currency or net settlements with other banks arising out of the transactions of its customers. However, the size of these reserves does not need to

more than some fraction of the bank's total deposit liabilities since there is virtually no chance that its customers as a group will wish to withdraw any large proportion of their balances at the same time.

31. The chartered banks taken as a group can induce the public to acquire more of their deposits in exchange for securities or loan obligations if they offer sufficiently attractive prices or lending terms, but unlike the Bank of Canada they can only do so if they have cash reserves in excess of their minimum requirements. In Canada, each chartered bank is required by the Bank Act to maintain cash reserves in the form of Bank of Canada notes and/or deposits with the Bank of Canada equal on the average during each calendar month to not less than 8 per cent of its Canadian dollar deposits. The total amount of cash reserves available to the chartered banks as a group is determined by the Bank of Canada in a manner consistent with its general objectives in the field of credit policy.

32. Within the chartered banking system the ability of any one bank to increase its assets (including the necessary cash reserves) depends upon the extent to which it can, in competition with other banks, persuade the public to hold more of its obligations, i.e., its deposits. Competition among the chartered banks for the limited supply of cash reserves thus takes the form of competition for deposits chiefly by such means as providing better services, more convenient branch locations, etc.

33. The Bank of Canada and the chartered banks

are not the only debtors in Canada who issue obligations which serve as money or close substitutes for money. (In this submission financial institutions other than the chartered banks whose liabilities serve as money or close substitutes for money are referred to as "near-banks".). Trust companies, credit unions, Quebec Savings banks, and provincial savings offices also issue deposit obligations which can be transferred by cheque or redeemed on demand in legal tender or its equivalent. Moreover, a wide variety or short-term obligations offered by trust and mortgage loan companies, instalment finance companies and investment dealers -- and indeed by governments and business corporations as well -- provide the holder with interest-bearing claims which can be converted into money at early maturity dates (or even before maturity, if need be, with little risk or loss of capital value) and these compete with the deposits issued by chartered banks, especially time and notice deposits. The debtors who issue such obligations must also ensure that they have sufficient cash and liquid reserves to meet their obligations when due.

34. The form in which cash reserves are held is not the same for all financial institutions. The chartered banks are required to maintain their cash reserves in the form of Bank of Canada notes and deposits with the Bank of Canada. The two savings banks that operate under the terms of the federal Quebec Savings Bank Act maintain part of their cash reserves in Bank of Canada notes, part in deposits at the Bank of Canada,

are not the only [illegible] in Canada who issue obligations which serve as money or close substitutes for money. (In this submission financial institutions other than the chartered banks whose liabilities serve as money or close substitutes for money are referred to as "near-banks".) Trust companies, credit unions, Quebec Savings banks, and provincial savings offices [illegible] issue deposit obligations which can be transferred by cheque or redeemed on demand in legal tender or its equivalent. Moreover, a wide variety of [illegible] obligations offered by trust and mortgage loan companies, instalment finance companies and investment dealers — and issued by governments and business corporations as well — provide the holder with interest-bearing claims which can be converted into money at maturity dates (or even before maturity, if need be, with little risk or loss of capital value) and thus compete with the deposits issued by chartered banks, especially term and notice deposits. The [illegible] who issue such obligations must also ensure that they hold [illegible] cash and liquid reserves to meet their obligations [illegible] [illegible].

4. The way in which cash reserves are [illegible] is not the same for all financial institutions. The chartered banks are required to maintain [illegible] reserves in the form of Bank of Canada notes and deposits with the Bank of Canada. The [illegible] banks that operate under the terms of the Quebec Savings Bank Act maintain part of their cash reserves [illegible] Canada notes, and in deposits at the [illegible] [illegible]

and part in deposits at the chartered banks. Trust companies, mortgage loan companies, credit unions and finance companies hold some Bank of Canada notes but most of their cash reserves are held in the form of deposits with the chartered banks and some of them have lines of credit with the banks which can be drawn on to replenish their cash reserves if necessary. Regardless of the form in which its cash reserves are held, any particular financial institution can acquire additional cash without giving up other assets only if the public decides to hold more of its obligations. It can induce the public to acquire more of its obligations in exchange for legal tender or some other form of money if the terms it offers are sufficiently attractive, but it is unlikely to do so unless it is thereby enabled to acquire assets whose yield is sufficiently high to give it an adequate margin of profit over the additional costs it incurs.

35. The "near-banks" are not in exactly the same business as the chartered banks on either the lending or deposit side. The differences between them are differences of degree rather than kind. In the case of some institutions their business may resemble the banking business very closely, but in most cases the "near-banks" are not in the short-term lending or deposit business to anything like the same extent as the chartered banks even after allowing for absolute differences in size. Some accept demand deposits and operate chequing accounts for their customers but this is a relatively small part of their business as a group.

[illegible] quirements of the chartered banks. [illegible]

[illegible] loan companies, trust [illegible]

[illegible] companies hold some cash [illegible], notes and

[illegible] cash reserves are held in the form of

deposits with the chartered banks and some of them have

lines of credit with the banks [illegible] to

replenish their cash reserves if necessary. [illegible]

of the form in which its cash reserves are held, any

particular financial institution can acquire additional

cash without giving up other assets only if the [illegible]

decides to lend more of its [illegible]. If the [illegible]

[illegible] to acquire more of its obligations [illegible]

[illegible] legal tender or some other form of money [illegible]

[illegible] offers are sufficiently attractive, but it is

unlikely to do so unless it is [illegible]

acquire assets whose yield is [illegible]

[illegible] adequate margin [illegible]

[illegible].

[illegible] "[illegible]" [illegible]

[illegible] as the chartered banks [illegible]

[illegible] deposit side. [illegible]

[illegible] differences [illegible]

[illegible] some [illegible] their [illegible]

[illegible]

[illegible]

deposit business [illegible], like the [illegible]

[illegible] chartered banks [illegible]

[illegible] in size. [illegible]

operate chequing accounts for [illegible]

[illegible]

Apart from personal loans, the same is true so far as the extension of short-term credit is concerned. Many "near-banks", such as the trust and loan companies, tend to hold a much higher proportion of their assets in the form of longer-term instruments such as mortgages and provincial, municipal and corporate securities; a relatively high proportion of their own obligations are in forms such as certificates and debentures which are somewhat longer in term and less liquid than savings deposit accounts.

36. Partly because of these differences, the rates of growth in the total assets and liabilities of the chartered banks and of the various types of "near-banks" show considerable diversity, although in a broad way their rates of expansion tend to accelerate or slow down together. A particularly strong demand for mortgage credit, for example, will especially favour the growth of those types of "near-banks" which specialize in this field of lending; they will be able to charge a relatively high rate of return on their mortgage loans and thus be able to make the rate of return offered on their certificates and debentures sufficiently attractive to induce the public to increase substantially its holdings of these obligations. A particular type of lending institution may also display an usually rapid rate of growth for a considerable period because it succeeds in developing new techniques or new fields of lending which enable it to compete more vigorously for the savings of the public.

37. In spite of the differing characteristics

[illegible] from personal loans, the [illegible] is true so far as the extension of short-term credit is concerned. Many [illegible] banks", such as the trust and loan companies, tend to hold a much higher proportion of their assets in the form of longer-term instruments such as mortgages and provincial, municipal and corporate securities, a relatively high proportion of their own obligations are in forms such as certificates and deposits which are sometimes longer in term and less liquid than savings deposit accounts.

36. Partly because of these differences, the rates of growth in the total assets and liabilities of the chartered banks and of the various types of "near-banks" show considerable diversity, although in a broad way their rates of expansion tend to [illegible] together. A particularly [illegible] mortgage credit, for example, will [illegible] the growth of those types of "near-banks" [illegible] in this field of lending, who will [illegible] relatively high rates of return on their [illegible] and thus be able to [illegible]

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to induce the public to [illegible] holdings of these obligations. A [illegible] lending institution may [illegible] rate of growth for a considerable period, because it succeeds in developing new techniques [illegible] writing which enable it to compete [illegible] the savings of the public.

37. In spite of [illegible]

with which the chartered banks, the "near-banks" and indeed other types of financial institutions endow their obligations in order to make them attractive to the public, there is a sense in which all of them are in competition for the public's favour. The extent to which any one of these financial institutions is able to expand its share of the market depends largely on its success, in competition with others, in persuading the public to take up and hold its obligations on terms which leave a margin for the profitable employment of the funds obtained. The terms which it is able to offer to the public depend in turn on the yields available on the kind of financial assets which it wishes to acquire, and on the efficiency with which it conducts its operations.

The Repercussions of Central Bank Transactions on the Financial System

38. Subsequent paragraphs trace the mechanics and repercussions of central bank operations designed to bring about an easing or tightening of any given credit situation. It is convenient to make certain assumptions about the initial situation. It is assumed that, at the prevailing set of securities prices, interest rates and other terms and conditions applicable to particular types of financial claims, debtors are reasonably satisfied with the size and composition of their outstanding debt, investors are reasonably satisfied with the size and composition of their financial assets, and chartered banks and other financial intermediaries are reasonably satisfied that they have

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The Repercussions of Central Bank Operations on the Financial System

33. Subsequent paragraphs trace the repercussions and repercussions of central bank operations designed to bring about an easing or tightening of any given credit situation. It is convenient to start with assumptions about the initial situation. It is assumed that, at the prevailing set of market yields, interest rates and other terms and conditions applicable to particular types of financial claims, debtors are reasonably satisfied with the size and composition of their outstanding debt, investors are reasonably satisfied with the size and composition of their financial assets and real [illegible] and [illegible] [illegible] are [illegible]

fully expoointed whatever profitable opportunities are open to them to expand their holdings of the particular types of assets and liabilities they specialize in. In this situation, the chartered banks will have cash reserves equal to 8 per cent (or, since banks do not like to run too close to the line, very slightly more than 8 per cent) of their deposit liabilities. When the central bank takes action to increase the amount of its obligations outstanding, the chartered banks and other financial intermediaries which accept short-term funds are put in a position to expand their assets and liabilities. While any of these intermediaries may be involved at any stage of the process this description will, in the first instance, be limited for purposes of brevity to the chartered banks alone. The description is greatly simplified; a fuller account of the working of the cash reserve system in practice appears in Submission III, The Techniques of Monetary Policy.

The Effect of Bank of Canada Operations on the Chartered Banks

39. Suppose that the Bank of Canada takes action to increase total cash reserves by purchasing $8 million of securities from an investment dealer. This in itself may have some initial direct influence on Government security prices and interest yields in the same way as the transactions of any other participant in the securities market, but there are indirect effects on monetary and credit conditions as well. The investment dealer will probably take the Bank of Canada cheque to his chartered bank and when settlement takes place the cash reserves of that bank, the total cash

them to expand their holdings of the [illegible] types of assets and liabilities they specialize in. In this situation, the chartered banks [illegible] ever equal to 8 per cent [illegible] too close to the [illegible] very slightly more than 5 per cent) of their deposit liabilities. When the central bank takes action to increase the amount of its obligations outstanding, the chartered banks are [illegible] are not in a position to expand their assets and liabilities. While any of these intermediaries may be involved at any stage of the process this description [illegible] in the first instance, be limited for purposes of [illegible] to the chartered banks [illegible]. The description is greatly simplified; a fuller account of the working of the cash reserve system is [illegible] of Commission III, The Techniques of Monetary [illegible] The Effect of Bank of Canada Operations on the [illegible]

11. Suppose that the Bank of Canada [illegible]

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[illegible]

[illegible] deposit [illegible]

[illegible] cash [illegible]

[illegible] the cash reserves of that bank [illegible]

reserves, will have increased by $8 million. As a result of central bank action the position of a chartered bank has changed so that it now has on the asset side $8 million more in cash reserves and on the liability side $8 million more in deposits. The increase in the assets and liabilities of the chartered bank is not the end of the matter, however, because that chartered bank now has more cash reserves than it needs; in other words, it is in a position to increase its earning assets. It may invest most of the $8 million, say $7 million, in securities. When the chartered bank pays out the money for the securities it will lose cash reserves unless it happens to buy the securities from one of its own depositors who redeposits the money with it. But even if it does lose the whole $7 million cash reserves, they are not lost to the banking system as a whole. The funds will be deposited at another chartered bank and that bank will find itself in a similar position to that of the first bank when it experienced an increase in cash reserves. Thus although there has been an increase of only $8 million in the cash reserves of the system, chartered bank deposits have already risen $15 million, and there still remain in existence more cash reserves than the banks as a group need. Assuming no other factors are at work to change the cash reserves of the system, this process of expansion of chartered bank assets and liabilities will continue until the expansion of deposits reaches the point where all the added cash reserves are needed to meet the banks' minimum legal requirements. Other things

reserves, will have increased by $3 million. As a result of central bank action the position of a chartered bank has changed so that it now has on the asset side $3 million more in cash reserves and on the liability side $3 million more in deposits. The increase in the assets and liabilities of the chartered bank is not the end of the matter, however, because the chartered bank now has more cash reserves than it needs; in other words, it is in a position to increase its earning assets. It may invest most of the $3 million, say $2.7 million, in securities. When the chartered bank pays out the money for the securities it will lose cash reserves unless it happens to buy the securities from one of its own depositors who redeposits the money with it. But even if it does lose the $2.7 million cash reserves, they are not lost to the banking system as a whole. They flow into the deposits of another chartered bank and that bank will then find itself in a similar position to that of the first bank which experienced an increase in cash reserves. Thus far there has been an increase of only $3 million in the cash reserves of the system, but chartered bank deposits have already risen $5.7 million, and there still remain [illegible] more cash reserves than are needed at this [illegible]. Assuming no [illegible] the cash reserves of the system, the process of expansion of chartered bank assets and liabilities will continue until the expansion of deposits has brought the [illegible] to the [illegible] cash reserves [illegible]

being equal, this will happen when total deposits have risen by $100 million, so that the minimum cash reserve requirement of 8 per cent of deposits will have required the full $8 million increase in cash reserves. The combined balance sheets of the chartered banks would have changed in the following way:

Change in Assets		Change in Liabilities	
Cash reserves	$ + 8 million	Deposits	$ +100 million
Securities	+ 92 million		
Total Assets	+100 million	Total Liabilities	+100 million

The position of the general public would have altered as follows:

Holdings of securities $ -100 million (of which $8 million went to the Bank of Canada and $92 million to the chartered banks).

Holdings of Bank Deposits $ +100 million.

The people who received the "new" bank deposits would in the first instance be those who gave up the securities in exchange. Some of the deposits will be held in current accounts and some in savings accounts, depending on the preferences of the holders.

40. Similarly, a decrease in cash reserves would cause chartered banks to reduce their holdings of securities or other assets in an effort to restore their cash positions, leading to a reduction in their total assets and total deposits and a corresponding change in the structure of the general public's financial assets and liabilities.

The Effect of Bank of Canada Operations on "Near-Banks".

41. Assuming that no change occurs in the relative attractiveness of chartered bank deposits as compared with closely competing liquid assets such as demand or time deposits, short-term paper, certificiates, etc. issued by "near-banks", there is no reason to suppose that the public could be induced to add to its holdings of chartered bank deposits without adding to its holdings of these other types of liquid assets as well. At any stage in the process of expansion described in paragraph 39 some of the sellers of securities may prefer to acquire a deposit with, or a short-term note or certificate of, one of the "near-banks" rather than a chartered bank deposit. Even in the initial transaction with the Bank of Canada the seller of the $8 million in securities might deposit the proceeds in a "near-bank", say, a trust company. This would not, of course, put an end to or interfere with the process of multiple expansion of chartered bank assets and liabilities outlined above since the trust company would deposit the Bank of Canada cheque for $8 million with a chartered bank. The trust com½any would have added both to its deposit liabilities to the public and to its cash reserves, but since it too is a chartered bank depositer the chartered banks as a group would have experienced the same increase in their cash reserves. If "near-banks" are successful in attracting funds from the public and finding profitable opportunities for acquiring the kinds of assets they specialize in they too will gain cash reserves and participate in the

process of expansion as well as the chartered banks. To the extent that an expansion of total chartered bank assets and liabilities consequent upon an increase in cash reserves is accompanied by an expansion of those of "near-banks", the degree to which credit conditions ease will be greater than would otherwise have been the case.

42. It will be noticed that so far as any particular financial institution is concerned it cannot participate in the expansionary process until it acquires additional cash reserves as a consequence of its customers increasing their holdings of its obligations. Each financial institution is thus in constant competition with others to promote the holding of its obligations. Competition may take the form of providing higher yields on short-term obligations, or obligations with terms carefully tailored to the requirements of customers, or additional services or more convenient branch locations. If one institution is able to do these things more successfully than others it will gain cash reserves and be able to expand its assets even without the injection of additional cash into the system. If, on the other hand, a financial institution fails to place with investors increased amounts of its obligations in competition with other financial institutions it will not be able to increase its assets even though additional cash reserves are injected into the system by the central bank and a general expansionary process is occurring.

43. The foregoing rather mechanical and over-

process of expansion as well as the chartered banks. To the extent that an expansion of total chartered bank [illegible] cash reserves is accompanied by an expansion of [illegible] of "near-banks", the degree to which credit conditions ease will be greater than would otherwise have been the case.

42. It will be noticed that so far as any particular financial institution is concerned it cannot participate in the expansionary process until it acquires additional cash reserves as a consequence of its customers increasing their holdings of its obligations. Each financial institution is thus in constant competition with others to promote the holding of its obligations. Competition may take the form of providing higher yields on short-term obligations, or obligations with terms carefully tailored to the requirements of customers, or additional services or more convenient branch locations. If one institution is able to do these things more successfully than others it will gain cash reserves and be able to expand its assets even without the injection of additional cash into the system. If, on the other hand, a financial institution fails to keep pace with investor preferences and needs of the customers in comparison with other financial institutions it will not be able to increase its assets even though additional cash reserves are injected into the system by the central bank and a general expansionary process is occurring.

43. The foregoing rather theoretical and [illegible]

simplified example indicates how the injection of additional cash reserves by the central bank percolates through the system and induces one bank after another to increase its assets and liabilities until the full potential of the extra cash is used up, and how it is also likely to result in some expansion of "near-bank" assets and liabilities. As the expansion of the public's holdings of relatively liquid financial assets proceeds it is bound to have some effect on security prices, interest yields and credit availability since, unless investors' asset preferences change, they will not be willing to sell securities to financial institutions in exchange for more liquid claims unless they are offered higher prices for them. Further upward pressures on prices is likely to result as the sellers of the securities seek to reinvest the proceeds, at least in part, in other securities.

44. To summarize, the acquisition of Government securities by the central bank is accompanied by a direct increase in the cash reserves of the chartered banks (and likely also by an indirect increase in the cash reserves of "near-banks") and this leads to a secondary expansion of the assets and liabilities of the chartered banks and also of the "near-banks". So far as the non-financial public is concerned, a larger proportion of its outstanding debt and financial assets will come to be held in indirect and less risky forms through intermediaries and a smaller proportion held directly. The initial purchase of securities by the central bank and particularly the secondary expansion

simplified example indicates how the injection of additional cash reserves by the central bank permeates through the system and induces one bank after another to increase its assets and liabilities until the full potential of the extra cash is used up, and how it is also likely to result in some expansion of "near-bank" assets and liabilities. As the expansion of the public's holdings of relatively liquid financial assets proceeds it is bound to have some effect on security prices, interest yields and credit availability since, unless investors' asset preferences change, they will not be willing to sell securities to financial institutions in exchange for more liquid claims unless they are offered higher prices for them. Further upward pressure on prices is likely to result as the sellers of the securities seek to reinvest the proceeds of sales in part, in other securities.

14. To summarize, the acquisition of government securities by the central bank is followed by a direct increase in the cash reserves of the chartered banks (and likely also by an indirect increase in the cash reserves of "near-banks") and this leads to a secondary expansion of the assets and liabilities of the chartered banks and also of the "near-banks". As far as the non-financial public is concerned, a larger proportion of the outstanding debt and financial assets will come to be held in indirect and less risky forms through intermediaries and a smaller proportion held directly. The initial purchase of securities by the

of financial assets of the chartered banks and other financial intermediaries will tend to place upward pressure on security prices and downward pressure on interest rates. The liquidity of the public will have been increased. A reduction in its holdings of securities by the central bank has exactly the opposite effect.

The Response of Chartered Banks to Changes in Cash Reserves

(The matters discussed in paragraphs 45 to 49 are treated in considerably more detail in Submission III, The Techniques of Monetary Policy.)

45. In practice, of course, the process described above does not operate in anything like so simple or mechanical a fashion. In the over-simplified example used to illustrate the process of expansion of chartered bank assets and deposit liabilities it was assumed that the chartered banks responded to an increase in their cash reserves by purchasing securities. There are in fact a number of alternatives open to a chartered bank. If it feels it would like to add to its very liquid assets it may employ the additional funds in day-to-day loans to money market dealers which can be called for repayment at any time. Or the chartered bank may purchase treasury bills. (By agreement with the Bank of Canada and among themselves each chartered bank maintains a minimum ratio of liquid assets in the form of cash reserves, day-to-day loans and treasury bills equal on the average each month to 15 per cent of its Canadian dollar deposit liabilities -- calculated on the same statutory basis as for cash reserve requirements). If the chartered bank feels that its liquid asset position is

of financial assets of the chartered banks and other financial intermediaries will tend to place upward pressure on security prices and downward pressure on interest rates. The liquidity of the public would have been increased. A reduction in the holdings of securities by the central bank has exactly the opposite effect.

The Significance of Chartered Banks' Cash Reserves

(The methods discussed in paragraphs [illegible]5 to 4[illegible] are treated in considerably more detail in Chapter III, The Techniques of Monetary Policy.)

45. In practice, of course, the process described above does not operate in anything like so simple or mechanical a fashion. In the over-simplified example used to illustrate the process of expansion of chartered bank assets and deposit liabilities it was assumed that the chartered banks responded to an increase in their cash reserves by purchasing securities. This [illegible] a number of [illegible] assets [illegible]. [illegible] reason it may result [illegible] additional [illegible] the money market dealers [illegible] or [illegible] day-to-day loans [illegible] treasury bills. [illegible] and money [illegible] e.g. the chartered bank [illegible] a minimum ratio of liquid assets in the form of cash reserves, day-to-day loans, and treasury bills [illegible] the cash reserve [illegible] deposit liabilities — equivalent to [illegible] for cash reserve requirements. If the chartered bank feels that its liquid asset position [illegible]

high enough it may purchase short-term Government bonds or it may add to its net foreign currency assets. If short-term yields are relatively low it may purchase medium-term Government securities. If the chartered bank feels that its security holdings and its over-all liquid position are adequate for some time to come it will at some stage adopt a more aggressive lending policy. In practice, a bank cannot vary the amount of funds it puts into loans in the same smooth fashion as it can in the case of securities because its lending policy can only be made known to its hundreds of lending officers across the country through written instructions and consequently is likely to change less frequently and by larger degrees than it would if the bank's lending were concentrated in a few hands as its security operations are. In any case much depends on the borrower. For example, a bank might wish to increase its loans but if business is slow its customers might not see profitable opportunities for using additional bank loans.

46. The linkage between the central bank's monetary policy and the trend of bank loans is therefore quite loose in practice. The direct influence exerted by the central bank through the level of cash reserves is on the total assets and total liabilities of banks as a group, and the effect on the trend of their loans will be cushioned by changes in their holdings of more liquid assets. In a period when the demand for loans is weak an increase in chartered bank assets will take the form mainly of a build-up in their relatively liquid

high enough it may purchase short-term government [illegible]

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[illegible] term yields are relatively low it may purchase medium-term government securities. If the chartered bank feels that its security holdings and its overall liquid position are adequate for some time to come it will at some stage adopt a more aggressive lending policy. In practice, a bank cannot vary the amount it puts into loans in the same smooth fashion as it can in the case of securities because its lending policy can only be made known to its hundreds of lending [illegible]

[illegible]

and consequently is likely to change less frequently and by larger degrees, than it would if the bank's lending were concentrated in a few hands as its [illegible] operations are. In any case much depends on the [illegible]. For example, a bank which [illegible] its loans [illegible] to allow its customers [illegible] and see profitable opportunities for making additional bank loans.

4. The linkage between the central bank's [illegible] monetary policy and the trend of its loans is, [illegible] quite loose in practice. The direct influence exercised by the central bank through the level of cash reserves [illegible] bank assets and total liabilities [illegible] [illegible], and the effect on the trend of their loans will be conditioned by changes in their holdings of [illegible] liquid assets. In a period when the demand for loans is weak an increase in chartered bank assets will [illegible] the form mainly of a building up in their holdings [illegible]

assets despite their growing capacity and willingness to lend. In a period when the demand for loans is strong and total bank assets are allowed to increase only moderately the banks will for a time respond mainly by selling securities in order to accommodate the increase in loans. Eventually, however, they may find it necessary to become more selective in their lending policies, because they will be reluctant to see their holdings of Government securities, their main reservoir of liquidity, decline beyond a certain point and because the strong demand for credit and the heavy sales of securities by banks will be accompanied by falling security prices and banks will be reluctant to incur the losses involved in security sales.

Cash Reserve Management in Practice

47. The illustration given above of the process of expansion of the assets and liabilities of banks and "near-banks" traced the changes that occur in response to an assumed increase in cash reserves brought about on the initiative of the central bank. Cash reserves may also at times be increased through standing arrangements that leave the initiative with the money market dealers or the chartered banks. When a bank has suffered a reduction in its cash reserves it will probably call day-to-day loans previously made to money market dealers and the latter, in accordance with existing arrangements, may come to the Bank of Canada and sell short-term Government of Canada securities to the Bank with an agreement to repurchase them within a short period. The effect on cash reserves is the same

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to loans. Eventually, however, they may find it

necessary to become more selective in their lending

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of liquidity, decline beyond a certain point [illegible]

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[illegible] received in security [illegible]

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4. [illegible]

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[illegible]

as in the case of an outright purchase by the Bank except that it is a temporary one. In other situations a chartered bank may come directly to the Bank for a short-term advance and this of course produces an immediate increase in the cash reserves of that bank. The minimum rate at which the Bank of Canada makes advances to the chartered banks or enters into purchase and resale agreements with money market dealers under these arrangements is called the Bank Rate. In order to encourage banks and dealers to try to raise the funds they want from market sources rather than the central bank, the Bank Rate is normally somewhat above the day-to-day loan rate as well as the 91-day treasury bill rate). In practice, however, changes in total bank assets more often originate elsewhere, for example, in the demand for bank loans and in the pressure of credit demands on financial markets generally, and the typical process is more accurately described as one in which the central bank has to decide whether and to what extent to respond to these developments. In a period when the demand for credit is strong and bank loans are rising rapidly, the central bank does not have to take any initiative to stimulate an increase in bank credit but it does have to decide how far it should go along in providing the cash reserves that would result in the increase in bank loans being accommodated through an increase in the total assets of the banks and in the "money supply" rather than through a reduction of the banks' more liquid assets. Similarly when the demand for loans is declining strongly the central bank has to

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increase in bank loans being [illegible]

increase in the total [illegible]

[illegible]

[illegible]

[illegible]

decide on the extent to which this will be reflected in a decline in the "money supply" or an increase in the banks' more liquid assets.

48. Although it would be possible for the Bank of Canada, with its power to control the cash reserves of the chartered banks within narrow limits to operate on the basis of a precise view about the appropriate trend, over some preiod, of total chartered bank assets (or of the "money supply", in the sense of currency outside banks plus chartered bank deposits), it does not in practice do so. The central bank is, of course, inevitably influenced in its judgments by developments in the "money supply", but it must also take a view of the kind of credit conditions that would seem to be appropriate in the light of the current and prospective state of the economy including the external financial position and it must be prepared within limits to use its control of cash reserves as the situation develops in whatever direction is necessary to try to bring about and maintain those conditions. This may mean that on occasion the Bank of Canada allows changes in its own and in total chartered bank assets to absorb pressures developing in financial markets rather than see credit conditions tighten or ease to an undesirable extent.

49. There is, of course, no formula by which the central bank can determine what are the most appropriate credit conditions or what level of cash reserves would bring them about. It must operate to a considerable extent by the method of successive

...ide on the extent to which this will be reflected in a ...tion in the "money supply" or an increase in the ... of liquid assets.

48. Although it would [illegible] Bank of Canada, with its power to control the cash reserves of the chartered banks within narrow limits, [illegible] operate on the basis of a precise view about the appropriate trend, over some period, of total [illegible] bank assets (or of the "money supply", [illegible] currency outside banks plus chartered bank deposits), [illegible] does not in practice do so. The central bank is, of course, inevitably [illegible] in the [illegible] level changes in the "money supply". But it must [illegible] take a view of the kind of credit conditions [illegible] ment to be appropriate in the light of [illegible] prospective state of the economy [illegible] financial position and it must be prepared [illegible] to use its control of cash reserves as [illegible] develops in whatever direction is necessary [illegible] bring about and maintain those conditions. [illegible] [illegible] [illegible] pressures developing in financial markets [illegible] credit conditions [illegible]

49. There is, of course, no [illegible] central bank can determine what are the most appropriate credit conditions [illegible] would bring them about. It must depend to [illegible] considerable extent on the method of judgement.

approximation, constantly adjusting its operations in the light of all the evidence it can get, as it becomes available, about changing economic and financial conditions.

50. If the central bank is to conduct its operations in such a way as to contribute to the achievement of such goals as sustained growth in production and employment, stability of prices and a satisfactory external financial position, it is clear that it must have accurate, up-to-date information about the performance of the economy. This problem is common to all public economic policies. It takes time to collect information; it is seldom possible to know in detail what the situation is at the time action must be taken. The availability of economic statistics has improved greatly but there are still some gaps, and some time lag must always be unavoidable.

51. With the existing lags in information the central bank often finds itself in a position where it must react to developments in financial markets without knowing for certain whether these reflect underlying trends in the economy or only short-run fluctuations in expectations which can cause important if temporary distrubances in markets.

52. Monetary policy must attempt to take account of a second important time lag -- the period between the time when credit conditions change and the time when there is an impact on the economy. Some effects may be felt quite rapidly, as for example those on international capital flows, while others may take

ation, consciously at making the control [illegible] in the light of all the evidence it can get, as it becomes available, about changing economic and financial conditions.

50. If the central bank is to conduct its operations in such a way as to contribute to the achievement of such goals as sustained growth in production and employment, stability of prices and a [illegible] external financial position, it is clear that it must have accurate, up-to-date information about the performance of the economy. This problem is common to all public economic policies. It would like to have [illegible] information [illegible] as soon as [illegible] to know in detail what the situation is at the time [illegible] are taken. The availability of economic [illegible] has improved greatly but there are still some gaps and some time lag must always be unavoidable.

51. With the existing gaps in information on the [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] without knowing for certain whether they [illegible] underlying trends in the economy or only [illegible] fluctuations in expectations [illegible] of temporary disturbances [illegible].

52. Monetary policy [illegible] [illegible] [illegible] [illegible] [illegible] of a second [illegible] [illegible] between the time when credit [illegible] time when this is apparent [illegible] effects may be very [illegible] [illegible] [illegible] [illegible]

more time to work themselves out. Even after businesses and consumers become aware that the availability and cost of credit have changed they may still take a certain amount of time to make adjustments in their plans to spend or save. The central bank should therefore try to gear its policy to the economic situation as it expects it to be some time ahead, not necessarily as it is now or was at the last date for which adequate information is available. If the central bank waits, for example, until productive capacity is almost fully utilized and the price level starts to rise before it begins to follow an anti-inflationary policy, damage will be done before its policy begins to be effective. There is a similar problem around the time of a downward turn in the business cycle.

53. With the present state of information and methods of analysis it is not possible to be absolutely sure what the trend of economic activity will be even a few months ahead. As a basis for its operating decisions, the best the central bank can do is to reassess continuously the economic situation and outlook, to narrow down the range of probable trends as much as it feels it safely can and to become aware of any divergence between actual and expected trends as quickly as possible.

54. Certain problems of a technical nature arise in the day-to-day management of cash reserves, relating to the structure of the banking system and to the way in which the minimum cash reserve ratio is

[illegible]

[illegible] and cost of credit have changed they may still take a certain amount of time to make adjustments in their plans to spend or save. The [illegible] should therefore try to gear its policy [illegible] as it appears it to be some time [illegible] [illegible] as it is not or was at the last [illegible] [illegible] information is available. [illegible] [illegible] for example, until productive [illegible] is almost fully utilized and [illegible] [illegible] before it begins to follow an [illegible] policy, damage [illegible] policy [illegible]. There is [illegible] [illegible]

[illegible] With the present state of [illegible] [illegible] of [illegible] it is not possible [illegible] [illegible] the [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] range of probable [illegible] [illegible] it [illegible] [illegible] [illegible] as possible.

[illegible] problems of [illegible] [illegible] day-to-day management of [illegible] [illegible] the structure of the banking system and [illegible] the [illegible] [illegible]

defined. These problems are discussed in Submission III, The Techniques of Monetary Policy.

The Nature of Central Bank Influence on Credit Conditions

55. This section considers in a more general way the role of banks and other intermediaries in the financial process and how the central bank is able to affect credit conditions by influencing the scale of their operations.

56. The activity which goes on in financial markets may be thought of as a continuous effort on the part of borrowers, lenders and investors to achieve a structure of outstanding debt and financial asset holdings which is mutually satisfactory in respect both of liquidity and yield, given the circumstances and prospects of the time. Individuals, businesses and even government (in some degree) are limited in the extent to which they can directly match off among themselves the types of debt some are willing to supply and others are willing to hold. Situations constantly arise in which a substantial part of the demand for funds comes, for example, from individuals wishing to incur long-term mortgage debt in order to finance the purchase of new homes, while a substantial part of the supply of funds comes, say, from business firms wishing to invest temporary surpluses in short-term securities. Much of the debt which borrowers want to incur involves risks of default or limited saleability or capital loss on disposal which are either too high or too difficult to ascertain to attract many lenders even at high interest rates. Financial intermediaries

such as banks, finance companies, trust and mortgage loan companies, credit unions, life insurance companies and pension funds, however, can pool the particular risks of individual debts in large and varied portfolios which have relatively low and predictable risk characteristics. These intermediaries operate by acquiring financial claims on ultimate borrowers of the kinds which siut the borrower's requirements and issuing financial claims on themselves, in a wide variety of different and specialized forms, to meet the portfolio needs of ultimate lenders or investors. They are essentially dealers in debts, who take up from the public substantial amounts of relatively long-term illiquid, unmarketable or risky claims such as mortgages, bonds and consumer debt and issue in their place claims such as currency, demand and time deposits, investment shares and certificates, life insurance and pension claims. The claims so issued generally offer greater liquidity, marketability, security of capital value or usefulness for specialized savings purposes than the corresponding assets acquired by the intermediaries concerned. The efficiency in borrowing and lending and diversification of risks which large scale operation permits enables these institutions, within certain limits, to offer the lender a better return on his investment, consistent with the risk he is willing to take, and to charge the borrower a lower cost on his borrowings, consistent with the conditions he is willing to undertake, than either could secure on his own, while still leaving the intermediaries some margin of profit for performing

their function.

57. Other things being equal, the larger the proportion of money and near-money claims to riskier, longer-term, less liquid or less readily marketable debt instruments in the portfolio of financial assets held by consumers and business the lower will be the level of interest yields and the easier will be credit conditions. It is the ability of the central bank to stimulate or restrain the "manufacture of liquidity" through the conversion of private and public debts into money or near-money claims by the commercial banks and other intermediaries which gives the central bank its influence over the availability and cost or return on funds in financial markets.

58. The trend of the "money supply" and changes in the size and composition of chartered bank assets are thus seen to be of major concern to the Bank of Canada not as ends in themselves, but rather as the means through which it can exert an influence on all those factors which affect the willingness and ability of ultimate spenders, directly or through recourse to financial intermediaries, to incur debt or part with financial assets in order to exercise command over goods and services. The relevant factors include the levels of interest rates on loans and deposits of various kinds, the prices and interest yields of securities, the amounts of particular groups in the economy and by banks and other financial intermediaries. It is the continuing responsibility of the central bank

their function.

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58. The trend of the "money supply" and changes in the size and composition of chartered bank assets are thus seen to be of major concern to the central bank not as ends in themselves, but rather as the means through which it can exert an influence on all those factors which affect the willingness and ability of ultimate spenders, directly or through recourse to financial intermediaries, to trade debt or other financial assets in order to obtain current goods and services. The relevant factors include the levels of interest rates on loans and debt issues of various kinds, the prices and interest yields of securities, the amounts of particular groups in the economy and by banks and other financial intermediaries. It is the continuing responsibility of the central bank to

to appriase and re-appraise the changing liquidity position of financial institutions and the public in the light of factors such as these and in the light of the over-all economic situation to exert an independent discretionary influence of its own through the operations which it conducts. The decisions to be made by the central bank concern the degree to which it can appropriately attempt to offset or reinforce such other influences as are affecting credit conditions at the time.

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other influences as are affecting credit conditions [illegible]

E. Some Practical Considerations in Monetary Policy

59. Monetary policy is a useful instrument in practice principally because it can exert an important influence on credit conditions in the direction judged to be appropriate in the economic circumstances. In the first section of this paper reference was made to the broad objectives of economic policy and these were taken to include sustained economic growth at high levels of employment and efficiency, internal price stability and a sound external financial position, and considerations of economic equity and freedom. It was stated that these were also the broad objectives of monetary policy. Central banks feel a particular obligation for seeing that in the consideration given to the proper "mix" of public policies adequate emphasis is at all times placed on price stability, that is, on the preservation of the purchasing power of money; being in a position to exercise an influence on the volume of money, they must inevitably be concerned with its value.

60. The position of the central bank would be extremely difficult if there were, as is sometimes asserted, a basic incompatibility between price stability and sustained economic growth. Fortunately there does not appear to be any such basic incompatibility and there are not adequate reasons for supposing that a proper concern for preventing erosion in the value of money will jeopardize the chances of achieving sustained economic growth and other policy objectives. On the contrary, it seems likely that economic growth

C. [illegible] Considerations in Monetary Policy

79. Monetary policy is a useful instrument [illegible] principally because it can exert an important influence on credit conditions in the direction judged to be appropriate in the economic circumstances. In the first section of this paper, reference was made to the broad objectives of economic policy and these were taken to include sustained economic growth at high levels of employment and activity, reasonable price stability and a sound external financial position, and a satisfactory distribution of economic activity and income. It was stated that these were also the broad objectives of monetary policy. Central banks feel a particular obligation for seeing that in the interpretation given to the proper "mix" of these objectives adequate emphasis is placed upon [illegible] price stability, that is, on the preservation of the purchasing power of money, being [illegible] [illegible] its influence on the volume of spending [illegible] [illegible] be consistent with its value.

80. The position of the central bank [illegible] [illegible] of these aims, and is [illegible] [illegible], a basic incompatibility between price stability and sustained economic growth. [illegible] there does not appear to be any real basis [illegible] and there are not adequate reasons [illegible] a proper concern for preventing inflation [illegible] money will [illegible] the chances of [illegible] sustained economic growth and other objectives [illegible] On the contrary, it seems likely that economic [illegible]

at high levels of employment and efficiency can be more readily sustained under conditions of reasonable price stability than with substantially rising prices. It has been the experience of many countries that inflation impairs the efficient performance of the economy and progressively undermines its ability to maintain a high rate of employment and productivity and to keep its balance of payments in a sound condition in a competitive world. Moreover, considerations of equity argue strongly in favour of price stability, for inflation is widely regarded as being very unjust in its effects. The central bank's concern with preserving the value of money is not in conflict with or a limitation on the constructive use of monetary pllicy in pursuit of the community's economic objectives.

61. Monetary policy has certain advantages over some other types of public policies which are directed towards influencing economic activity. One advantage is that it can be adjusted almost from day to day, whereas policies affecting public expenditures, taxation, and debt management are less flexible. Another advantage is that it involves no direct intervention by Government in the plans of individuals and businesses, provinces and municipalities; no one of these, nor any group of them, nor any particular kind of activity is singled out for attention. The central bank operates only at the centre of the financial system -- the Government securities market and the cash reserves of the chartered banks -- and it relies on the impersonal functioning of financial markets to

Levels of employment and efficiency can be much readily maintained under conditions of reasonable price stability than with persistently rising prices. It has been the experience of many countries that inflation impedes the efficient performance of the economy and progressively undermines its ability to maintain a high rate of employment and productivity or to keep its balance of payments in a sound condition in a competitive world. Moreover, considerations of equity argue strongly in favour of price stability, for inflation is widely regarded as being very unjust in its effects. The central bank's concern over preserving the value of money is not in conflict with or a limitation on the constructive use of monetary policy in support of the country's economic development.

67. Monetary policy [illegible]

transmit the effects of its policies through the rest of the economy.

62. Control over the cash reserves of the chartered banks gives the Bank of Canada control over the total assets and total deposits of the chartered banks as a group, but at the same time it leaves the chartered banks, which are privately-owned, free to compete among themselves for banking business. Each bank can, by competing for deposits, attempt to gain as large a share as possible of the total cash reserves made available by the Bank of Canada to the banks as a group. The central bank has no power over the distribution of chartered bank assets; it controls indirectly only the total for banks as a group. Subject to the statutory 8 per cent minimum cash ratio and the agreed 15 per cent minimum liquid asset ratio, each bank decides for itself what proportion of its assets it will hold in the various categories, how much it will put into loans and to whom it will lend. Each bank may if it wishes alter the distribution of its assets, for example, by selling securities and making more loans. Anyone who is refused a loan by one bank is free to apply to one or all of the others. In this system the distribution of bank credit is a matter which is entirely worked out between the chartered banks and their customers. The central bank has no power to direct the chartered banks, or any other financial institutions, to lend, or not to lend, to any person or business or government, or in any region and it has no power to establish direct regulation of credit.

through the efforts of the [illegible] through the pool of the economy.

(d) Control over the cash reserves of the chartered banks gives the Bank of Canada control over the total amount of bank deposits of the chartered banks as a group but at the same time it leaves the chartered banks, which are privately-owned, free to compete among themselves for banking business. Each bank can, by competing for deposits, attempt to gain as large a share as possible of the total cash reserves made available by the Bank of Canada to the banks as a group. The central bank has no power over the distribution of chartered bank assets; it controls indirectly only the level for banks as a group. Subject to the statutory 8 per cent minimum cash ratio and the agreed 15 per cent minimum liquid asset ratio, each bank decides for itself what proportion of its assets it will hold in the form of [illegible], what it will put into loans and [illegible] it will [illegible] over any of its [illegible] the [illegible] for example, by [illegible] [illegible] [illegible] [illegible] [illegible] to [illegible] the [illegible] of [illegible] which is [illegible] the [illegible] [illegible] [illegible] in [illegible] the commercial [illegible] [illegible] [illegible] to [illegible] [illegible] or [illegible] [illegible]

Its powers are largely confined to controlling the total cash reserves of the chartered banks. It enables the public sector to exert an influence on general credit conditions while leaving the banking business and other financial business to be run by the private sector of the economy.

63. The corollary of the fact that the impact of monetary policy on any particular unit or group in the economic system cannot be controlled or indeed even precisely forecast, many however be regarded as a disadvantage where specific rather than general measures seem necessary. Since the operations of the central bank in the sense of cash reserve management can exert only a general influence on over-all credit conditions it cannot deal with the special problems of particular industries and regions.

64. The influence of central bank action is transmitted through the economy by financial markets, and if financial markets worked perfectly the effect on different groups in the economy would be reasonably even. In actual fact, because of certain rigidities and imperfections in financial markets and because of certain tax arrangements, the effect of changes in credit conditions on the various categories of potential borrowers is often quite uneven -- so uneven that if credit conditions were allowed to become too extreme the results might become intolerably inequitable.

65. One example of the potentially uneven effect of changes in credit conditions relates to the case of relatively small borrowers. While both large

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92. The [illegible] of the fact that the [illegible] of monetary policy or any particular unit or group [illegible] [illegible] [illegible] cannot be [illegible] [illegible] [illegible] precisely [illegible], must however be regarded [illegible] [illegible]

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94. The influence of central bank [illegible] is transmitted through the economy by financial markets, and if financial markets [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] groups in the economy would be [illegible] [illegible]. [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible], [illegible] [illegible] [illegible] credit, [illegible] [illegible] the [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]

95. One example [illegible] [illegible] [illegible] [illegible] effect of changes in credit conditions [illegible] [illegible] [illegible] relatively small borrowers [illegible] [illegible]

and small businesses borrow from the chartered banks, only the larger ones have the alternative open to them of obtaining money by offering new issues in the securities markets. If chartered banks did not feel a special concern for making adequate credit facilities available to credit-worthy small borrowers at all times, these borrowers would have great difficulty on occasion in obtaining their credit needs. Even in the case of larger borrowers the effect of changing credit conditions may be quite uneven because some can obtain funds from outside Canada, from parent or affiliated companies or from foreign securities markets, while most, in terms of numbers, are limited to Canadian sources of funds.

66. If central bank operations are to have a relatively uniform effect throughout the economy, there must be a sufficient diversity of financial institutions which specialize in meeting the needs of particular categories of borrowers.

67. The effects of central bank operations may be uneven if there are certain interest rates which are not flexible, whether because of legal restrictions or institutional practices. Funds made available at rates of return below market levels will be limited in total and this will tend to discriminate in favour of those who can obtain loans at this rate as against those who cannot, and especially against those in the latter category who have no alternative source of funds.

68. Tax arrangements may give rise to some of the unevenness of the impact of changes in interest

rates. Since the interest cost of borrowed money to corporations is an expense and therefore deductible from taxable income, a substantial part of any rise or fall in such costs to the corporation is often regarded as being offset by changes in tax liabilities. By contract, provincial and municipal government and others, including those who borrow through mortgages to finance owner-occupied housing, feel the full effect of any rise or fall in the cost of their borrowing.

69. Another problem is that not all groups in the economy respond in an "economic" way to changes in credit conditions. It is clear, for example, that consumers are rather insensitive to changes in the cost of consumer credit. It is also clear that many people do not bother to look for ways to maximize the return on their savings even allowing for their liquidity requirements. It is probably also the case that many corporations do not try to maximize the return on temporary surplus funds although many of the larger ones have become quite active in this respect.

70. In addition to the difficulties associated with the uneven impact of changes in credit conditions there are other reasons why there must be limits to the extent to which the level of interest rates can be allowed to rise or fall and the extent to which credit rationing can be allowed to become more stringent or less so. One of these reasons is the effect on financial markets themselves. Financial markets, particularly securities markets, are similar to other markets in that everyone expects a certain amount

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company, provincial and municipal governments and

others including those who [illegible] mortgages,

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of price fluctuation in response to changes in demand and supply. There must, however, be some limit to the degree of price fluctuation which financial markets can be expected to sustain if they are to function efficiently and if the general public is to continue to be willing to acquire and hold marketable financial assets, other than very short-term claims, on a large scale.

71. Another consideration which has implications for the use of monetary policy is the country's external financial position. Views that may be formed from time to time regarding the monetary policy that is appropriate in the circumstances will be influenced by the level and trend in the foreign exchange reserves as well as by internal developments.

72. For the reasons which have been outlined above an important consideration in the use of monetary policy is that if there were excessive reliance on this instrument the desired effect on the level of spending could, in some circumstances, involve tighter credit conditions than would in fact be tolerable. Apart from the specific difficulties which have been mentioned, it is only realistic to recognize that credit conditions can become too extreme to be accepted by the public -- in the same way that tax rates can become too high. Monetary policy -- like fiscal policy -- is dependent in the end on a reasonable degree of public acceptance.

73. The fact that monetary policy is subject to these limitations may tend to inhibit the central bank to some extent when a policy of ease is appropriate

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71. Another consideration which may [illegible] recommendation for the use of [illegible] policy is the country's [illegible] 'internal position'. [illegible] fixed [illegible] policy [illegible] [illegible]

72. [illegible]

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because it will be very conscious of the limitations which it will face in attempting to keep the more liquid situation under control later on. This may be particularly true if it feels that the possibility of the reappearance of inflationary pressures is not too remote, and if it is not confident that adequate support from other public policies will be forthcoming at that stage.

74. A monetary policy of extreme case may under certain conditions be subject to the possibility of perverse reactions in financial markets. Because of the association by investors of large-scale monetary expansion with inflation during the war and post-war period in many countries, extreme monetary ease might at some stage cause a loss of confidence in the purchasing power that long-term bonds would command when they matured. Another possibility is that investors might come to feel that bond prices could rise no further, and would fall sharply sooner or later if the higher liquidity was to be kept under control. In such circumstances investors might lose interest in buying or holding long-term bonds, thereby exerting an influence on interest rates opposite in direction to that of the monetary expansion,

75. In summary, the job of monetary policy is to assess the nature and impact of all the factors bearing on credit conditions and to decide whether in the circumstances it should allow them to be fully reflected in credit conditions, or whether and to what extent it should try to reinforce of mitigate their

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71. A necessary [illegible] of [illegible] is a [illegible]
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effect. In any set of circumstances there are limits to the range within which it is practical for monetary policy to allow or encourage credit conditions to vary, but within the range it can influence credit conditions in the direction appropriate in the circumstances. Its influence will be most effective if monetary policy and fiscal and debt management policies are closely co-ordinated. While monetary policy cannot carry the whole burden of the job in regulating the general level of spending in the economy and maintaining a saitsfactory external financial position, it can in combination with other public economic policies make an important contribution.

APPENDIX

STATEMENT BY THE GOVERNOR OF THE BANK OF CANADA ISSUED AUGUST 1, 1961

I have been greatly encouraged by the many public expressions of goodwill which have appeared since the announcement of my appointment as Governor of the Bank of Canada. I have decided to make public at this time my views on certain matters connected with the administration of this office. These views had been made known to the Directors and to the Government in the following form when my appointment was being considered.

I believe that it is essential that the responsibilities in relation to monetary policy should be clarified in the public mind and in the legislation. I do not suggest a precise formula but have in mind two main principles to be established: (1) in the ordinary course of events, the Bank has the responsibility for monetary policy, and (2) if the Government disapproves of the monetary policy being carried out by the Bank it has the right and the responsibility to direct the Bank as to the policy which the Bank is to carry out.

The first principle is designed to ensure that the Bank has the degree of independence and responsibility necessary if it is, in the language of the Bank of Canada Act, "to regulate credit and currency in the best interests of the economic life of the nation". To discharge this duty the Bank must be sufficiently independent and responsible in its operations to be able to withstand day-to-day pressures from any source.

ANNEX

STATEMENT BY THE GOVERNOR OF THE BANK OF CANADA [illegible]

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I believe that it is essential that the respective responsibilities in relation to monetary policy should be clarified in the public mind and in the legislation. I do not envisage a precise formula but there are two principles to be established: (1) in the ordinary course of events, the Bank has the responsibility for monetary policy, and (2) if the Government disapproves of the monetary policy being carried out by the Bank it has the right and the responsibility to direct the Bank as to the policy which the Bank is to carry out.

The first principle is designed to ensure that the Bank has the degree of independence and responsibility necessary if it is to [illegible]

[illegible]

But in the longer run, if there should develop a serious and persistent conflict between the views of the Government and the views of the central bank with regard to monetary policy which, after prolonged and conscientious efforts on both sides, cannot be resolved, the Government should be able formally to instruct the Bank what monetary policy it wishes carried out and the Bank should have the duty to comply with these instructions. The exercise of this authority by Government would place on Government direct responsibility for the monetary policy to be followed. If this policy, as communicated to the Bank, was one which the Governor felt he could not in good conscinence carry out, his duty would be to resign and to make way for someone who took a different view.

Amendments to the Bank of Canada Act would presumably be required to deal with these points. If, however, it were agreed that the respective responsibilities should be of the general character I have indicated, there should be little difficulty in regard to the precise nature and timing of the necessary changes.

I wish, secondly, to place on record some of my views on the way in which monetary policy fits into other public policies affecting the economic and financial welfare of the nation. I take it that the broad aim of the community is to attain, to the maximum extent possible, certain generally accepted objectives: high level employment, price stability and sustained economic growth. A flexible monetary policy is an

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and Russia [illegible] conflict between the wishes of the

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to armistice policy, which, under existing policy and

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the Government should be able formally to [illegible]

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for the armistice policy to be followed. If this [illegible]

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[illegible]

essential element in the total blend of policies directed to these ends. In a situation characterized by large unemployment and unused capacity, monetary policy should be directed to encouraging the use of credit. On the other hand, if the economy is approaching a condition of full stretch, policy should be directed towards discouraging the use of credit.

Too much reliance on monetary policy either as a restraining or a stimulating factor would, however, lead to unsatisfactory self-defeating results. If one were to try to control the excesses of a boom period through monetary policy without adequate support from appropriate fiscal, debt management and other economic policies of Government, one would run the risk of creating great strains in the financial system in the form of intolerably high interest rates and disorganization in capital markets. On the other hand, the precise part that monetary policy can appropriately play in stimulating economic expansion is necessarily influenced by the part being played by the concurrent fiscal, debt management and other economic policies of Government. The central bank has an important part to play in influencing the trend of interest rates in a direction appropriate to the economic situation. But an attempt on its part to impose a level of interest rates which appeared unrealistic to the market would impair confidence in the value of the currency and present a serious obstacle to the orderly flow of funds through the capital market.

What is said in the previous paragraph is not

meant to deprecate the contribution that monetary policy can make towards attaining the broad economic objectives of high-level employment, price stability and sustained economic growth. On the contrary, it is meant to underline the need for a careful and consistent meshing together of all the various aspects of financial policy and general economic policy in the effort to attain these objectives while avoiding undue strains in particular sectors. In particular, since monetary policy, fiscal policy and debt management policy are interdependent and to some extent interchangeable, there has to be a high degree of coordination to ensure that the blend or "mix" of these policies is purposefully directed towards attaining the over-all economic objectives of the community.

The views expressed above regardint the respective responsibilities of Government and Bank for monetary policy and the need for close coordination of monetary, fiscal, debt management and other economic policies point to the great importance of close and continuous contact between the Bank and the Government. I shall wish to play my full part in achieving the close working relationship with the Minister of Finance which is indispensable if the Bank is to discharge its responsibilities in a satisfactory way. I would hope to have frequent contacts with the Minister of Finance of the same character as I have had over the past years in my capacity of Executive Director of the International Monetary Fund and International Bank. In addition, in order to ensure beyond doubt

sure, to legislate the contents of their monetary

policy can make tough the obtaining the dual economic objectives of high-level employment, price stability and sustained economic growth. On the other hand, we underline the need for a careful and consistent meeting, together of all the various tools of financial policy and general economic policy if the efforts to attain these objectives are to be [illegible] unduly straining in particular sectors. In particular, since monetary policy, fiscal policy and debt management policy are interdependent and to some extent interchangeable, there is need for a high degree of coordination to assure that the efforts of [illegible] policy [illegible] complement [illegible] overall objectives of the Community.

[illegible] also [illegible]

[illegible] policy and [illegible] management, [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]

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that continuing high importance is attached to maintaining lines of communication, and even though such precaution may now seem unnecessary, consideration should be given to setting up a routine procedure for regular meetings at fairly frequent intervals between the Minister of Finance and the Governor.

May 31, 1962.

Submission by the Bank of Canada to the
Royal Commission on Banking and Finance

III. THE TECHNIQUES OF MONETARY POLICY

III - THE TECHNIQUES OF MONETARY POLICY

A. General Considerations in the Choice of Techniques

Introduction

1. This submission deals with some of the tecnhical aspects of central bank operations in Canada. (A simplified description of the existing cash reserve system and the mechanics of changes in the level of cash reserves resulting from changes in the various asset and liability items on the Bank of Canada's balance sheet is given in a note appended to this submission entitled The Control of Chartered Bank Cash Reserves by The Bank of Canada.) Before these are discussed in detail it may be useful to refer to some of the broader issues involved.

2. In our submission on The Role of Monetary Policy we stated that in our view one of the main responsibilities of the central bank is to exert an influence on credit conditions, the appropriate direction and magnitude of which will depend on all the other influences at work in financial markets and on the central bank's view of the current economic situation. By "credit conditions" is meant the whole range of terms and conditions affecting borrowing and lending and the purchase and sale of financial assets.

3. The main technical basis for the central bank's ability to influence credit conditions lies in the fact that its liabilities have the status of legal tender and serve as cash reserves for the commercial banking system. It can buy or sell assets such as Government securities in such amounts as it considers

VII - [illegible]

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Introduction

1. This memorandum deals with some of the technical aspects of central bank operations in Canada. (A simplified description of the existing bank reserve system and the mechanics of changes in the level of bank reserves resulting from changes in the various asset and liability items on the Bank of Canada's balance sheet is given in a note appended to this submission entitled The Control of Cash and Liquid Reserves by the Bank of Canada.) Before these are discussed it would be well to refer to some of the broader issues involved.

2. In our submission on [illegible] Policy we stated that in our view one of the main responsibilities of the central bank is to [illegible] influence on credit conditions, the [illegible] and [illegible] of credit [illegible] and the [illegible] at work in financial markets and [illegible] general [illegible] of the economy [illegible] by "credit conditions" is meant the [illegible] [illegible] purchase and sale of financial assets.

3. The most [illegible] the central bank's ability [illegible] the fact that [illegible] the [illegible] [illegible] and [illegible] [illegible]

appropriate and in this and other ways increase or decrease the banks' cash reserves, and so stimulate or restrain the expansion of the commercial banking system. This basic technique can be used in different ways, some of which have much more direct and detailed effects on the prices and yields of Government securities than others. There are also a number of supplementary techniques which can be used to exercise a direct influence on the availability of credit through particular institutional channels or for particular purposes. These depend on persuading or requiring lenders to observe certain rules in the allocation of funds at their disposal. Some of these techniques have a much more direct and detailed impact on the normal functioning of lending institutions than others.

4. There are many possible combinations of methods by which a central bank can seek to exert its influence on credit conditions and central banks differs considerably in their general operating approach, partly because the structure of the financial system differs from country to country. Few central banks rely exclusively on a single approach; most prefer to use a variety of operating techniques, depending on the circumstances of the time. To provide some indication of the various approaches open to a central bank, several broad alternatives are outlined below in paragraphs 5 - 15; each is described in rather extreme form to bring out clearly its essential features. The general approach preferred by the Bank of Canada is then described in paragraph 16 - 17.

Influencing Credit Conditions Indirectly Through Variations in Cash Reserves

5. At one extreme, the central bank would try to influence credit conditions exclusively through the mechanism of cash reserve management and would try to avoid any action which might have a direct impact on interest rates except at the very short end of the market for Government securities. With the chartered banks operating on the basis of reasonably stable cash ratios, variations in the supply of cash reserves would be expected to initiate a chain of institutional and market responses whose ultimate effects on the cost and availability of credit would be broadly in line with the central bank's general objectives, although neither predictable nor controllable in detail. If the central bank wanted to exert its influence on the side of ease it would be more liberal in providing cash reserves. More plentiful cash reserves would tend to stimulate a secondary expansion of the assets and liabilities of banks and other credit institutions, inducing them to add to their investments and loans with a corresponding increase in their deposit liabilities to the public. In the process of acquiring increased holdings of securities and loan obligations in exchange for their deposit liabilities, the institutions involved would tend to push down interest rates, or limit the rise which would otherwise occur in a period of strongly expanding economic activity. Market mechanisms would be relied on to spread this influence to yields on securities of all types and maturities, and also at some

stage to affect the non-price terms of access to credit stipulated by banks and other institutional lenders. If the central bank wishes to exert its influence on the side of restraint it would work in the opposite direction.

6. A major advantage sought by this approach is that the market is given as much freedom as possible, within the general environment influenced by the cash reserve management of the central bank, to place its own valuation on the securities issued by the Government. The central bank would not be seeking to impose any particular view regarding the appropriate structure of interest rates; it would be confining its operations in Government securities to the very shortest maturities. Indeed, it might even be able at many times to bring about desired changes in cash reserves without entering the securities market at all, through a number of techniques which will be discussed later.

Such an indirect approach would enable the central bank to exert a broad general influence on credit conditions. It would provide little control over the precise timing or detailed character of the resulting changes in interest rates and institutional lending and investment policies, but it would leave a great deal of leeway for the interplay of private decisions in working out the detailed pattern of interest rates, credit allocation, and the distribution of assets held by financial institutions and the public.

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2. A major advantage sought by this [illegible] is that the market is given as much freedom as possible within the general [illegible] framework [illegible] by the reserve management of the central bank. [illegible] on [illegible] the securities issued by the [illegible] the central bank would not be seeking to impose any particular view regarding the appropriate [illegible] of interest rates [illegible]

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Indeed, it might [illegible] many cases [illegible] about desired changes in [illegible] the authorities [illegible] at [illegible] techniques which [illegible]

[illegible] central bank [illegible]

central bank [illegible]

[illegible]

the process [illegible] changes in interest rates and [illegible]

[illegible]

Influencing the Level and Structure of Interest Rates Directly

8. At the other end of the spectrum, the central bank might, through its open market operations, seek to influence the level and structure of interest rates indirectly. The central bank might proceed by establishing the prices or effective interest yields at which it would be prepared, for the time being, to buy or sell Government securities of various maturities. In the light of market and institutional responses and the trend of economic event it would from time to time alter these prices. In effect, the central bank would try to bring about desired changes in certain key interest rates in the system directly and rely on market mechanisms to ensure that these were accompanied by appropriate changes in the cost of credit and in the other terms and conditions faced by potential borrowers.

9. Under a regime of this kind, changes in the amount of cash reserves held by the commercial banking system would become a by-product rather than a focal point of the central bank's open market operations. So long as the central bank maintained a particular set of buying and selling prices for various issued of Government securities, downward or upward pressure on these price levels would encounter the direct resistance of central bank purchases or sales, and, because of the consequent effects on the supply of cash reserves, the indirect resistance of credit expansion or contraction on the part of private financial institutions. It seems clear that under this method of operation the

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8. At the other end of the spectrum, the [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] the [illegible] and structure of [illegible] [illegible] industry. The central bank might proceed by establishing the policy of effective interest yields at which it would be prepared [illegible] the time being, [illegible] [illegible] government securities of various maturities. In the light of market and institutional reactions and on trend of economic events, it would from time to time [illegible] these patterns. In effect, the central bank would [illegible] be [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] rates in the market directly and [illegible] as market [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] changes in the [illegible] of credit and in the [illegible] [illegible] [illegible] and [illegible] [illegible] [illegible] [illegible] [illegible]

9. [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] the [illegible] of each [illegible]

fluctuations in the total assets and liabilities of the banking system would be greater than under the first approach described in this submission.

10. Such an approach would require the virtual fusion of monetary policy and debt management operations. The present system of offering specified amounts of treasury bills for sale by auction and of new issues of Government bonds for public subscription would not appear to be consistent with an approach of this kind and the logic of this approach would seem to involve changing the present system to one of tap issues of various maturities.

11. An undesirable consequence of this extreme approach would be to obscure the infouence of the many powerful domestic and international forces which are constantly at work in financial markets. Changes in the market prices of Government securities would appear on the surface to be merely the result of central bank action and this would make it much more difficult for the central bank to follow a flexible monetary policy. Moreover, the attention of dealers and investors would tend to concentrate on anticipating the next move of the central bank, and continuous short-run speculation rather than the appraisal of the underlying forces at work might well become the dominant activity in the Government securities market. The central bank would have a particularly difficult problem of coping with undesirable de-stabilizing shifts in market expectations generated by its own actions.

fluctuations in the total assets and liabilities of the banking system would be greater than under the limited measures described in this submission.

10. Such an approach would merge the separate function of monetary policy and debt management operations. The present system of offering specified amounts of treasury bills for sale by auction and of new issues of Government bonds for public subscription would not appear to be consistent with an approach of this kind and the logic of this approach would seem to involve converting the present system to one of tap issues of various maturities.

11. An undesirable consequence of this extreme approach would be to obscure the influence of the many powerful economic and international forces which are constantly at work in financial markets. Changes in the market prices of Government securities would appear on the surface to be merely the result of central bank action and there would seem in such cases little [illegible] the central bank to follow a flexible monetary policy. Moreover, the attention of savers and investors would tend to concentrate on anticipating the next move of the central bank, and sentiment would depend more on speculation rather than the assessment of the underlying [illegible] which market [illegible] between [illegible] demand [illegible]

[illegible] would involve a particularly difficult combination of [illegible] which [illegible] for clarifying [illegible] understanding generated by [illegible].

Influencing the Availability of Credit Directly

12. Both the approaches mentioned above rely heavily on market mechanisms and the profit-maximizing responses of institutions to transmit the effects of central bank action to all points of the credit system, the assumption being that both the cost and the availability of credit will tend to be affected and that it is desirable that both work together in influencing the demand for goods and services. In unusual circumstances, however, it may be a legitimate object of policy to aim specifically at influencing the availability of credit without necessarily affecting its cost to any important extent. The kind of measures used would depend on how extensive an influence was deemed necessary.

13. A minimal approach would be, in special circumstances, to try to exert some quantitative influence on the loan expansion of the chartered banks. For competitive reasons the chartered banks may on occasion, even in the face of a persistent decline in their holdings of liquid assets and Government bonds, delay adjustments in their lending policies longer than would be desirable from the point of view of containing excessive demands for credit. If there were pressing reasons for seeking an immediate impact on the availability of credit, it might be desirable for the central bank to be able to hasten the adjustment of lending policies by impounding some of the reserve liquidity of the chartered banks. Or it might be desirable on occasion to try to stimulate bank lending by releasing liquidity.

Influencing the Availability of Credit Directly

2. Both the approaches mentioned above rely [illegible] responses of institutions to transmit the effects of central bank action to all points of the credit system, the assumption being that both the cost and the availability of credit will tend to be affected and that it is desirable that both work together in influencing the demand for goods and services. In certain circumstances, however, it may be a legitimate objective of policy to aim specifically at influencing the availability of credit without necessarily affecting the cost to an important extent. The kind of measures used would depend on how extensive an influence was thought necessary.

3. A minimal approach would be, in certain circumstances, to try to exert some qualitative influence on the loan expansion of the commercial banks. The [illegible] even in the case of [illegible] officials of central banks and government [illegible] in their lending policies [illegible] influence from the point of view of [illegible] various objectives [illegible] [illegible] to achieve [illegible]

The techniques used for this purpose in various banking systems include variations in prescribed cash reserve or liquid asset ratios applicable to the banks or the calling up or releasing of special deposits maintained by these institutions at the central bank. Under these procedures, the qualitative decisions regarding the detailed allocation of credit would continue to be left to the judgment of the chartered banks themselves.

14. A much more far-reaching approach would be to aim at exercising, through central bank efforts or Government controls, a detailed and selective influence over the lending policies of a wide range of institutions, in respect for example of consumer credit contracts, mortgage contracts, offerings of new issues in the capital market and stock market credit.

15. If the chartered banks and other lenders could be persuaded or required to ration their loans more stringently or selectively, it is conceivable that a significant number of unsuccessful borrowers would refrain from pressing their demands for credit through alternative market channels, either because of the expectation of being refused, or on account of the additional cost or difficulty of borrowing elsewhere, or out of inertia. To this extent the credit expansion would be moderated with a smaller rise in interest rates than would otherwise occur. Measures of this general character, if used vigoroughly, could produce rapid and perhaps substantial changes in the availability of credit. Experience shows, however, that financial markets and institutions can in time adapt themselves to barriers to

systems include variations in preferred cash reserve or liquid asset ratios comparable to the banks or the building up or reducing of special deposits with these institutions at the central bank. Under these procedures, the qualitative decisions pertaining to detailed allocation of credit would [illegible] to the judgment of the concerned banks themselves.

14. A more [illegible] far-reaching [illegible] [illegible] controls, through selective credit [illegible] consumer controls, a detailed and selective [illegible] [illegible] lending practices of a wide range of [illegible] to suspend the [illegible] of consumer credit [illegible] mortgage contracts, [illegible] of real estate [illegible] [illegible] and [illegible].

15. [illegible] [illegible]

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the flow of credit; if particular channels of lending are obstructed they are likely to be circumvented as alternative indirect channels are created.

The Approach of the Bank of Canada to Monetary Management

16. In general the approach of the Bank of Canada to monetary management is much closer to the first method described in paragraphs 5 to 7 (i.e. influencing credit conditions indirectly through variations in cash reserves) than to any of the others. It is the view of the Bank of Canada that its responsibilities can best be discharged under arrangements which give the securities market and private lending institutions the maximum scope to perform their important functions in determining the terms and allocation of credit, and that central bank operations should leave as much room as possible for the exercise of private judgments in these matters. In most circumstances the aism of public financial policy can be pursued effectively without the central bank intervening in the Government securities market on a broad front with precise objectives for bond prices and interest rates, and without resorting to regulations or pressures designed to influence the allocation of credit in particular ways or through particular channels.

17. At the same time, the Bank of Canada feels that the techniques available to it should give it enough flexibility to discharge its responsibilities as circumstances may require. For example, in situations where the need arises to combat disorderly conditions in securities markets, or where a change in interest rate differentials between Canada and the United

[illegible]: if particular channels of lending are restricted they are likely to be circumvented as alternative indirect channels are created.

The Approach of the Bank of Canada to Monetary Management

16. In general the approach of the [illegible] method described in paragraphs 5 to 7 (i.e. influencing credit conditions indirectly through variations in cash reserves) than to any of the others. It is the view of the Bank of Canada that its responsibilities can best be [illegible] method and governs lending institutions the maximum scope to perform their economic functions in determining the terms and allocation of credit, and that general [illegible] should leave as much room as possible for the exercise of private judgment on these matters. In most circumstances the aims of public financial policy can be pursued effectively without the central bank [illegible] the Government [illegible] and interest rates, and without resorting to regulations or persuasion designed to influence the allocation of credit in particular ways or through particular channels.

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States is a matter of urgent importance, or where there is need for particularly close co-ordination with debt management operations, it may be desirable for the Bank to conduct limited open-market operations in mid-term or long-term securities; and it would not be desirable or practical for formal limitations to be imposed on the Bank in this respect. Similarly, it would seem unwise to rule out the possibility of involing more direct measures to control the availability of credit in an extreme situation. In certain circumstances, as has been indicated in our submission on <u>The Role of Monetary Policy</u>, there are limits to the extent to which and the rapidity with which interest rates can be allowed to rise, and there may therefore be times at which it is preferable to vary the cash reserve or liquid asset ratio or resort to moral suasion or selective credit controls than to allow the inflationary process to proceed without further resistance.

[illegible] unsafe if continued, or when, [illegible]

[illegible] for part [illegible] of [illegible] concerning [illegible] operations, it may be desirable [illegible] to [illegible] or [illegible] operations in [illegible] or long-term results; and it would not be [illegible] or practical for formal limitations to be imposed [illegible] in this report. Similarly, it would seem [illegible] to [illegible] the possibility of involving more [illegible] to control the variability of [illegible] [illegible]. In certain [illegible] in our [illegible] [illegible]

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B. Cash Reserve Management and Open Market Operations

Methods of Affecting Cash Reserves

18. There are a great many channels through which a central bank can inject cash into the banking system or withdraw it, and a great variety of assets that it can acquire or give up in exchange. As a practical matter, however, there are great advantages to limiting cash management operations to relatively few channels and relatively few types of financial assets, and to relying largely on market mechanisms to transmit the effects of central bank operations to other areas of the financial system. A central bank can exert a pervasive effect on credit conditions even though the direct effects of its operations are confined to the cash reserve position of the commercial banks and to the market for short-term Government securities.

19. In some countries the central bank provides cash reserves mainly by making advances to banks secured by commercial bills or similar private obligations or by discounting such paper. In earlier periods central banks dealt in private obligations to a considerable extent, no doubt partly because of the relatively small supply of government paper. In recent decades, however, and particularly since the Second World War, the size of the Government debt in the form of outstanding securities has made it both feasible and convenient for central banks in most countries to conduct their operations mainly in Government securities. So far as the Bank of Canada is concerned, Government of Canada securities have a number of advantages. They are

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available in a broad range of maturities and their value at maturity is guaranteed by the Government. They are widely held and traded by banks, other financial institutions, investment dealers and the general public. By operating in such securities the central bank is able to co-ordinate its own operations closely with those related to the management of Government debt.

20. The Bank of Canada has the power to buy and sell gold and foreign exchange but in practice it does not deal for its own account in gold at all and its dealings in foreign exchange for its own account, as distinct from those undertaken as agent for the Government, have been on a small scale in recent years.

21. The Bank of Canada purchases securities of the Industrial Development Bank as a means of providing funds to that institution but its purchases of such securities do of course have cash effects which must be taken into account in the central bank's ordinary cash management operations.

22. Within the range of financial transactions engaged in by the Bank of Canada there are many different ways of injecting or withdrawing cash. Some have a direct impact on the securities market while others do not and the choice of methods adopted by the central bank will depend in part on the nature of the impact sought. In some cases the Bank may achieve its cash reserve target without taking any initiative at all; for example, a decision not to offset a seasonal decline in note circulation in the hands of the public can bring about an increase in the chartered banks' cash reserves.

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[illegible] is guaranteed by the Government. They [illegible]
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[illegible]. The [illegible] of Canada [illegible] of the [illegible] Day [illegible] as a means [illegible] funds to [illegible] but its [illegible] of [illegible] [illegible] have [illegible] [illegible] in the [illegible]

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Cash reserves may be affected by temporary variations in the Government's deposit balance at the Bank of Canada (as explained in the appended memorandum). For example, a running down in the Government's deposit balances at the Bank in a period when the expenditures of the Government exceed its receipts injects central bank cash into the commercial banking system without passing through financial markets at all. This is also the case when part of the Government's deposit balance at the Bank of Canada is, with the concurrence of the Government, transferred to the Government's deposit accounts with the chartered banks. Other variations of this technique are possible. For example, the Bank of Canada might buy Government securities from the Securities Investment Account of the Government and the proceeds, after being credited to the Government's deposit account at the Bank, might be transferred to the Government's deposit accounts at the chartered banks. Or the Bank might buy foreign exchange from the Government and the Canadian dollar proceeds might be handled in the same way. The transfer of profits from the Bank of Canada to the Government provides another opportunity for affecting cash reserves; in recent years the Bank has transferred its annual profits to the Government in instalments during December and these funds, after being credited to the Government's deposit account at the Bank of Canada, have been transferred to the Government's deposit accounts at the chartered banks, thus offsetting the effect on cash reserves of a seasonal rise in note circulation. None of these methods has any direct impact

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into the commercial banking system without passing

through financial markets at all. This is also the case

when part of the Government's deposit balance at the Bank

of Canada is, with the concurrence of the Government,

transferred to the Government's deposit accounts with the

chartered banks. Other variations of this technique are

possible. For example, the Bank of Canada might buy

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account of the Government and the proceeds, [illegible]

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proceeds might be handled in the same way. [illegible]

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the Government's deposit account at the Bank of Canada,

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accounts at the chartered banks, thus [illegible]

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on the securities market; the market influence is first felt when the chartered banks react to the resulting increase of decrease in cash reserves. There are of course limits to the use of Government deposit transfers imposed by the amount of the available Government balances and their distribution as between the Bank of Canada and the chartered banks and by the desire of the Government to maintain working balances of reasonable size with the chartered banks at all times. In the main, transfers of Government funds between the Bank of Canada and the chartered banks -- draw-downs and re-deposits -- are undertaken to prevent the uneven flow of Government receipts and expenditures from affecting the level of cash reserves rather than for the purpose of changing the level of cash reserves.

23. Changes in its holdings of Government securities are the main technique by which the central bank affects cash reserves or offsets the effect of other factors, except on a very short-run basis. The Bank of Canada's holdings of Government securities can change as a result of the direct purchase of a new issue from the Government, or as a result of the repayment at maturity of an outstanding issue held by the Bank (including the issue and retirement of treasury bills at the weekly tender), or as a result of direct transactions with Government accounts as already indicated, or as a result of purchases and sales in the open market. Central bank operations in the open market, like security transactions conducted by others, are bound to have some direct impact on market prices and yields,

securities market; the market influence is that that when the chartered banks react to the resulting increase or decrease in cash reserves. There are of course limits to the use of government deposit transfers imposed by the amount of the available Government deposits and their distribution as between the Bank of Canada and the chartered banks and by the desire of the Government to maintain working balances of reasonable size with the chartered banks at all times. In the main, transfers of Government funds between the Bank of Canada and the chartered banks -- draw-downs and re-deposits -- are undertaken to prevent the uneven flow of Government receipts and expenditures from affecting the level of bank reserves rather than for the purpose of changing the level of cash reserves.

(b) Changes in its holdings of Government securities are the main technique by which the Central Bank effects cash reserves or offsets the effects of other factors, except on a very short-run basis. The Bank of Canada's holdings of Government securities can change as a result of the direct purchase of a new issue from the Government, or as a result of the redemption at maturity of an outstanding issue held by the Bank (including the issue and retirement of Treasury bills at the weekly tender), or as a result of direct [illegible]

[illegible] purchased, or as a result of purchases and sales in the open market. Central bank operations in the open market [illegible] security transactions conducted by either [illegible]

though the magnitude of such impact cannot be measured at all precisely. Broadly speaking, the shorter the term of the security

(i.e. the closer it is to the cash for which it is being exchanged) the smaller the direct impact. To take an extreme example, the purchase of a bond maturing the next day could be expected to have practically no direct impact on prices in the market. Due to the rapid development of the money market in recent years it is likely that the Bank's transactions will be a smaller proportion of total market transactions in the securities involved if they take place at the short end of the market. In carrying out open market operations to provide or withdraw cash reserves the Bank of Canada usually, though not always, chooses to deal in relatively short-term securities in order to minimize the direct impact of its transactions on the market. This approach is in keeping with the Bank's normal preference for trying to achieve its objectives indirectly (that is, mainly through bringing about changes in the cash reserves of the chartered banks and letting the responses of banks and others to this change work themselves out in the markets for various types of financial assets) and with the Bank's desire to encourage the development of broad, self-reliant markets for Government securities.

24. The central bank can normally rely on the changes in chartered bank assets and in the "money supply" which result from its cash management to exert an influence on credit conditions in the appropriate

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... The central bank ... in ...

direction. This influence is broad rather than precise. Chartered banks hold their liquidity mainly in the form of money market assets (day-to-day loans, treasury bills and short-term Government bonds), and their initial response to changes in cash reserves is generally to add to or reduce these assets. Consequently, the immediate effect of chartered bank responses to changes in cash reserves is in the short-term area of the securities market and in short-term yields, although over a longer period bank lending policies may be affected. The influence of the chartered banks' purchase or sales of securities will, of course, tend to spread to a certain extent through the whole range of maturities as investors adjust their portfolios in response to yield changes and to the shift which has taken place between short-term securities and bank deposits. Many investors and borrowers, though by no means atll, are able to shift their securities holdings or borrowing between the short-term area of the market and the long-term area. Consequently short-term yields and long-term yields are always to some extent inter-connected.

25. The Bank of Canada, however, cannot rely in all circumstances solely on the indirect influence that it can exert on interest rates through cash reserves. In certain situations, as has been mentioned earlier, the central bank may feel that it should engage in limited market transactions in medium and long-term as well as short-term securities. From time to time it may be desirable to combat disorderly market conditions as, for example, when the market needs assistance in

direction. This influence is broad rather than precise. Chartered banks hold their liquidity mainly in the form of money market assets (day-to-day loans, treasury bills and short-term Government bonds), and their initial response to changes in cash reserves is generally to add to or reduce these assets. Consequently, the immediate effect of chartered bank responses to changes in cash reserves is in the short-term area of the securities market and in short-term yields, although over a longer period bank lending policies may be affected. The influence of the chartered banks' purchase or sales of securities will, of course, tend to spread to a certain extent through the whole range of securities as investors adjust their portfolios in response to yield changes and to the shift which has taken place between short-term securities and bank deposits. Many investors and borrowers, though by no means all, are able to shift their securities holdings or borrowing between the short-term area of the market and the long-term area. Consequently short-term yields and long-term rates are also to some extent inter-connected.

25. The Bank of Canada, however, cannot rely in all circumstances solely on the indirect influence that it can exert on interest rates through cash reserves. In certain situations, as has been mentioned earlier, the central bank may feel that it should exert a limited direct influence in medium and long-term as well as short-term securities. There are times when it may be desirable to combat disorderly market conditions, as, for example, when the market faces substantial [illegible]

adjusting itself to unexpected shocks such as the substantial shifts of assets sometimes associated with large-scale private or public debt operations. The sensitivity of international flows of funds to changes in interest rates may on occasion provide another reason for the central bank to operate in a particular area of the market. Changes in long-term as well as short-term yield differentials between Canada and the United States can induce substantial flows of funds from one country to the other and thereby aggravate or ease exchange and other problems. Many countries experience large inflows and outflows of funds in response to changes in short-term interest rate differentials but it seems probable that there is no other country where the international flow of funds has been as sensitive to changes in long-term interest rare differentials as in Canada.

26. Recent experience in the United States provides a good example of a situation where the central bank has tried to exert some direct influence on the interest-rate curve for balance-of-payment reasons. In the United States the declared policy has recently been to keep short-term rates from falling too low and to keep long-term rates from rising too high. The Federal Reserve System has contributed to this objective by departing to some extent from its previous policy of confining its open market operations almost exclusively to the very short end of the market.

27. The need to co-ordinate central bank operations with Government debt management operations is

limiting itself to unexpected shocks such as the [illegible]

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27. The need to coordinate fiscal and

another reason why the Bank of Canada feels it should not rigidly restrict itself to dealing only in short-term securities. Some operations of the Bank designed to contribute to the debt management programme are described in Submission IV, The Role of the Bank of Canada in Debt Management.

28. The direct impact of securities transactions depends not only on the term to maturity of the securities but also on the manner in which the central bank operates in the market. For example, if it purchases securities by responding to an offer in the market when prices tend to be weak, the support which this transaction provides has some effect but it is not likely to have much impact on market expectations. The normal practice of the Bank of Canada is to respond to bids and offers made by others in the market. If the central bank were to enter the long-term market and bid up bond prices to deal with some exceptional situation the impact would depend on the view the market took of this intervention. If the market regarded the central bank's price as "artificial" its action could, perhaps after a speculative flurry, result in a weakening rather than a strengthening of market prices.

29. Each week at the treasury bill auction the Bank of Canada has the opportunity of trying to affect cash reserves by bidding for an amount of the new bills which is more or less than the amount of its holdings of maturing bills; alternatively, it can attempt simply to "roll over" its holdings. Its influence on the average tender rate depends on the size and prices of its

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bids. The bidding of banks and eealers will be affected to some extent by the cash reserve situation as well as by their expectations of market developments. However, the results of the auction may not affect the cash reserves of the chartered banks even in the direction (let alone to the extent) that the Bank of Canada would like to see, and the Bank may have to use other means of affecting cash reserves in order to bring about the changes which it regards as appropriate. Or the auction may result in an average tender rate which is quite inappropriate in the Bank's view, in which case it can manage the cash reserves of the banks subsequently in such a way as to attempt to exert the desired influence on short-term rates.

30. At the time of a new Government bond issue the Bank can normally add to its holdings of securities if it wishes. If the new issue is a refunding operation the Bank has the opportunity of increasing, or since it will probably hold part of the maturing issue, of decreasing its total holdings. Its action will be influenced by the effect it wishes to have on cash reserves and also on occasion by debt management considerations. It might, for example, choose to subscribe for less of the new issue than it holds of the old in order to be in a position to make supporting purchases of the new issue in case of need without increasing cash reserves unduly. If it should turn out that such support was unnecessary, the central bank would have to find some other way of adjusting the cash reserve situation.

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31. The Bank may also provide cash reserves through advances to banks and purchase and resale arrangements with dealers; these matters are discussed in Section C, "Central Bank Advances and Bank Rate".

32. The conditions prevailing in the securities market will affect the Bank of Canada's choice of the precise means to be used for injecting or withdrawing cash. Under certain conditions the Bank may wish to avoid any direct impact on the securities market. For example, if prices were already tending to be very strong the Bank, though faced with the need to inject additional cash (to provide, for example, for an outflow of note circulation), might wish to avoid adding to the upward pressure that would result if it provided the cash by buying securities in the strong area of the market. At other times it might feel that it was desirable to bring about an increase in cash reserves in a way which did provide some market support. If it were considered appropriate in particular circumstances to encourage a widespread feeling of tightness, the Bank might choose to defer providing cash until money market dealers approached the central bank for accommodation through purchase and resale arrangements.

33. Finally, the method which the Bank uses to change cash reserves will be influenced to some extent by the different timing of the cash effect of various kinds of transaction. In accordance with market practices, the delivery of a bond with a term to maturity of more than three years is made on the third business day after the transaction has been arranged, at which

[illegible]
Toronto, Ontario

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time payment is made, and the cash reserves of banks are affected the following day. Government bonds with a term to maturity of less than three years are delivered on the second day and the cash effect takes place on the third day. Treasury bills are delivered on the first day following completion of the transaction, so that the cash effect takes two days from the date of the transaction. Transfers of Government deposits between the central bank and the chartered banks are normally made at the end of the day and have cash effect on the following day. The cash effect of purchases of securities from money market dealers with resale agreements also occurs on the next day. In the case of advances to the chartered banks the cash effect is immediate.

34. In general, the present powers of the Bank of Canada provide it with an adequate range of effective techniques for controlling the cash reserves of the chartered banks. The object of controlling the cash reserves is of course to influence the chartered banks to add to, or to reduce, the total of their assets. While the central bank can control the cash reserves within quite narrow limits, the immediate response of banks may vary within rather wide limits and may in turn necessitate further cash reserve adjustments.

The Determination of the Extent of Changes in Cash Reserves

35. On a day-to-day basis the central bank must decide not only what kind of operations to undertake to affect the level of cash reserves but also the size of

those operations. To begin with, it must always take into account a variety of factors which will change the existing level of cash reserves if the central bank takes no offsetting action. Some of these factors will be known precisely -- for example, the amount of securities transactions entered into earlier, settlement for which will affect cash reserves that day. Others, chiefly the daily change in note circulation, must be estimated. In addition to allowing for the cash effect of outstanding transactions, including those entered into for reasons not directly related to cash management, and changes in cash resulting from the initiative of others, the central bank must form a judgment as to what level of cash reserves is likely to produce the desired response by the chartered banks.

36. Decisions regarding the appropriate size of changes in the cash reserves of the chartered banks are very much a matter of successive approximation, mainly because the short-run response of the banking system to given changes is quite variable. There are many reasons why banks as a group may respond rather differently at different times to the same over-all cash reserve situation, and under the existing legislation the minimum cash reserve requirements to which the banks are subject permit a fairly wide degree of latitude.

37. The idea that with a minimum 8 per cent cash reserve ratio chartered bank deposits can increase by $100 million only if the central bank has already increased cash reserves by $8 million is an over-simplification of what actually happens. Under present

arrangements changes in the level of a bank's deposit liabilities in the course of any month have no effect on the amount of cash reserves it is required to hold until the following month. The fact that an individual bank is likely to lose cash reserves to the other banks if it attempts to increase its assets more rapidly than the others undoubtedly exerts a restraining influence. Nevertheless, there have been increases in bank assets of as much as $200 million in the course of a few days without any concurrent increase in cash reserves on occasions when most or all of the banks have been responding to a common influence such as a sharp jump in loan demand or a new issue of Government securities.

38. The structural characteristics of the banking system as well as the cash reserve formula may play a part in this result. In a system with a large number of banks, none of which account for more than a small proportion of total deposits, each bank will expect to lose cash whenever it makes a loan or investment because the chance of the funds ending up with its own depositors is negligible. It is true that if all banks were expanding their assets at the same rate the cash reserve losses of each would be offset by cash reserve gains from others, but where there are many separate banks there would be almost no possibility that all would keep in step; the high degree of risk that there would be a loss of cash would tend to restrain any one bank from attempting to increase its assets rapidly. The smaller the number of banks, however, the greater chance there is that a substantial increase in the demand for

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25. The structural characteristics of the banking system as well as the cash reserve rules also play a part in this result. In a system with a large number of banks, none of which accounts for more than a small proportion of total deposits, each bank would expect to lose cash whenever it makes a loan or investment because the chance of the funds ending up with its own depositors is negligible. It is true that if all banks were expanding their assets at the same rate the cash reserve losses of each would be offset by cash reserve gains from others, but where there are many banks there would be almost no probability that all would keep in step; the high degree of risk that there would be a loss of cash would tend to restrain any one bank from attempting to increase its assets rapidly. The smaller the number of banks, however, the greater the chance there is that a substantial increase in the assets [illegible]

bank credit will produce about equal rates of increase in assets. To the extent that this happens each bank finds that additions to its assets have not in fact resulted in a loss of cash reserves. This can happen relatively easily in Canada where the chartered banks are eight in number and where three of them account for 70 per cent of total bank deposits.

39. If there is a large increase in deposits during one month the cash reserve requirements for the next month will of course rise sharply. The additional cash reserves required for banks as a group will have to be provided by the central bank by the end of the reserve period in one way or another, perhaps by way of advances to banks or purchase and resale agreements with dealers, but no individual bank can take it for granted that it will automatically get enough of the total amount of cash reserves in the system to be able to meet its own cash reserve requirements. Consequently, what the central bank can do with respect to an undesired increase in total bank deposits which has already occurred is to keep cash reserves low enough for a long enough portion of the current month or of subsequent months to induce individual banks to make net reductions in their total assets in an attempt to acquire the needed cash. The speed and magnitude of such responses determines the extent to which total chartered bank assets and total chartered bank deposits will be reduced. When it reduces cash reserves the central bank cannot foresee the exact changes in bank assets and deposits that will occur. On a day-to-day and week-to-week basis the

central bank must be prepared continuously to adjust cash reserves, to watch the response of banks and developments in the market, and to make further adjustments as necessary. In any given month the important question is not the absolute level of cash reserves but the difficulty or ease with which the banks are able to obtain their cash requirements. It is the case that over any long period, with an 8 per cent cash ratio, changes in total chartered bank deposits will be roughly twelve and one-half times the change in their cash reserves, but the process by which this relationship is maintained is indirect, complex and subject to considerable imprecision in the short run.

40. Day-to-day fluctuations in cash reserves are experienced by every chartered bank; they arise in part from central bank operations affecting total cash reserves and in part from inter-bank shifts in cash. If a bank feels it necessary or desirable to make an adjustment to a change in its cash position, its usual response is to reduce or increase its holdings of money market assets (day-to-day loans, treasury bills or short-term Government bonds). A tight cash position causes the banks to sell money market assets on balance, and a flushing-up of cash causes them to bid for additional money market assets. Bank holdings of money market assets serve as a cushion between changes in cash and changes in their other assets. If bank loans rise by a large amount or if banks subscribe for a large amount of an attractive offering of Government bonds, they can make offsetting reductions in their holdings of money

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market assets if they have to (provided of course that they have more than minimum holdings of such assets). Such reductions cannot directly force the central bank to supply additional cash to the system but it can put substantial -- even if temporary -- upward pressure on money market rates. So long as banks have an appreciable cushion of secondary liquidity the trend of their loans and the scale of their participation in new Government issues will be beyond any precise control through cash reserve management, and this would be true no matter how rigid was the system of reserve requirements.

41. Bank lending policies are not changed frequently, and the connection between them and the central bank action to control cash reserves is very loose. In a period of restraint, after there has been a significant reduction in the chartered banks' liquidity cushion of money market assets and Government bonds, perhaps accompanied by some realized losses on sales of securities, their lending policies will at some stage be tightened. In the short run, however, the trend of bank loans outstanding depends more on the demand of bank customers for credit than on changes in the lending policies of banks. Even when banks are disposing of liquid assets because cash reserves are tight there may still be an increase in total bank assets and in the "money supply" resulting from a large rise in loans.

42. Cash reserve management is a process of successive approximation in which the Bank of Canada is to some extent responding to actions of the chartered banks and to market developments just as the banks and

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the market are responding to Bank of Canada operations. While the Bank of Canada knows that the continued maintenance of a ratio of less than the 8 per cent minimum will sooner or later produce a very tight situation and induce banks to dispose of some of their liquid assets (and that the maintenance of a reserve ratio of well over 8 per cent will eventually produce an easy situation in which the banks add to their liquid assets), it cannot expect to achieve anything like precise control over the timing, magnitude or detailed character of bank responses. In one period a given cash ratio may be accompanied by net purchases of Government securities by the banks, perhaps because of their views concerning future market levels, while in another period with the same cash ratio the banks may keep their holdings of these assets steady or even reduce them. In one period the cash situation may, with a certain cash reserve ratio, appear to be quite easy throughout the month; at another the central bank may find that with precisely the same cash ratio the cash situation is tight and that it is called upon to provide additional cash under purchase or resale agreements with dealers or even advances to banks. A bank's response may be influenced by the trend of its loans; if loans are rising rapidly the bank may take a more serious view of a rather tight cash position than it would if it did not expect to experience continued drains of cash from that source. Or it may be influenced by its view of the central bank's policy. If it believes the central bank is following what is basically an easy credit policy, a

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chartered bank may regard a decline in total cash reserves as only temporary and in this case it will probably not react strongly. If, on the other hand, because the banking system as a whole has had to reduce its liquid asset holdings, it feels that the central bank is starting to apply a tighter policy the bank may begin to work to a slightly higher cash reserve target and at the same time begin to shorten its security portfolio.

43. Not all banks work to precisely the same cash reserve ratio targets and the response of banks as a group is therefore affected by the distribution of cash among them. Moreover, responses to changes in cash reserves will depend to some extent on how much of the monthly averaging period remains in which to achieve the required average level of reserves. If a bank experiences a change in cash reserves early in the month it has considerable time to make the necessary adjustments, whereas if it occurs late in the month and the bank's cumulative average cash ratio does not leave much margin above the legal minimum the reaction must be prompt. Again, policies in regard to the timing of adjustments tend to differ from bank to bank. One bank may attempt to correct its cash reserve position promptly while another may take more time. The daily cash ratios of some banks swing through a much wider range in the course of the month than others. As a consequence if one bank has a daily ratio of, say, 8½ per cent and another bank of about the same size has a ratio of 7½ per cent, the combined response of the two banks may be quite different from what it would be if they were both

at 8 per cent. In general, the limited ability of the Bank to preduct in advance the precise nature of the chartered banks' response to changes in cash reserves can be compensated for to a considerable extent by continuous adjustments in cash reserves as information about such responses becomes available; the Bank is greatly assisted in this respect by the fact that the chartered banks report statistics on a very current basis.

44. Although over the years the banks have worked progressively closer to the statutory minimum cash ratio, it will be clear from the above that under existing arrangements the Bank of Canada cannot maintain precise control over the total deposits of the chartered banks from day to day or from week to week. But the central bank does not need to have precise short-run control in order to pursue effectively its goal of appropriate credit conditions. Indeed the central bank cannot know in advance what rate of change in the "money supply" might be consonant with achieving such conditions. The central bank begins by working toward a certain level of cash reserves but it is prepared to respond to chartered bank actions and developments in the market. To some extent it may have to compromise between reducing temporary aberrations in short-term interest rates and smoothing temporary aberrations in the rate of growth of bank assets. No system could be guaranteed to do both simultaneously since the non-bank demand for both bank credit and money market assets is bound to be subject to temporary disturbances of greater or lesser extent at irregular and unpredictable intervals,

and a reasonable degree of flexibility in the system is desirable.

45. There must, however, be some limit to the amount of looseness or play in the linkages within the system. If banks did not aim at reasonably stable cash ratios but allowed these to undergo wide fluctuations, it would become very difficult to use cash reserves as a control mechanism and the central bank would have to rely on much more extensive open market operations either in an attempt to bring about larger swings in cash reserves or to have a more direct influence in the market. The longer the period covered by the minimum cash reserve requirement the more scope there is for delayed or erratic response. For example, if the minimum cash reserve requirement were applied to the average level over a six-month period, the response of banks to changes in cash in the early part of the period could be quite similar to their response under a system where there was no minimum requirement at all. At the other extreme, a requirement to maintain an exact ratio of cash reserves to deposits on a strictly current daily basis would produce an intolerably rigid situation. It is highly desirable that there should be some short-run elasticity in the "money supply" so that the banking system can quickly absorb the day-to-day shocks that result from sudden changes in the demand for credit or in the attitudes and desire for liquidity of investors or from sudden shifts in cash between banks. It is impossible for the central bank to know about all the factors that produce

and a reasonable degree of flexibility in the system is desirable.

45. There must, however, be some limit to the amount of looseness or play in the linkages within the system. If banks did not aim at reasonably stable cash ratios but allowed these to undergo wide fluctuations, it would become very difficult to use cash reserves as a control mechanism and the central bank would have to rely on much more extensive open market operations either in an attempt to bring about larger swings in cash reserves or to have a more direct influence in the market. The longer the period covered by the minimum cash reserve requirement the more scope there is for delayed or erratic responses. For example, if the minimum cash reserve requirement were applied to the average level over a six-month period, the response of banks to changes in cash in the early part of the period could be quite similar to their response under a system where there was no minimum requirement at all. At the other extreme a requirement to maintain an exact ratio of cash reserves to deposits on a strictly current daily basis would produce an intolerably rigid situation. It is highly desirable that there should be some short-run elasticity in the "money supply" so that the banking system can quickly absorb the day-to-day shocks that result from shifts or changes in the demand for credit or in the [illegible] and provide for liquidity of resources [illegible] such as in cash between banks. It is [illegible] central bank to know [illegible]

such developments in time for it to make the necessary adjustments in cash reserves and if the minimum cash reserve ratio were applied on a strictly current daily basis, the banks would undoubtedly aim at maintaining enough excess cash reserves to give them the minimum flexibility they need even though this involved some sacrifice of earnings.

46. In the light of all of these considerations it is by no means easy to form a precise view of what is the best formula for minimum cash reserve requirements. It seems desirable that the exact amount of deposits with the Bank of Canada which the chartered banks are required to hold on the average should be known to all concerned at the beginning of the reserve period. This means that the statutory figures for their own deposit liabilities and holdings of Bank of Canada notes should relate to an earlier period. The optimum period to which the requirement should apply is something that can be determined only by experience. The present view of the Bank of Canada is that the existing formula permits unduly slow responses and results in unduly large discontinuities in cash reserve requirements.

<u>Minimum Liquid Asset Ratio</u>

47. In every country the commercial banks hold some portion of their assets in relatively liquid form in order to be in a position to replenish their cash reserves quickly when necessary. In a period in which the demand for bank loans is strong, banks may allow their holdings of liquid assets to decline as a means of accommodating part or all of this demand.

However, a bank would not wish to run the risk of finding itself completely out of liquid assets, and well before the decline reached this point the bank would begin disposing of other available assets -- for example, somewhat longer-term securities -- or if necessary adjusting its lending policy. If there is no generally accepted minimum level for liquid asset holdings it is possible that the pressure of competition to make loans and the desire to avoid disposing of other assets (perhaps at realized losses) might on occasion cause some banks to allow their liquid assets to drop temporarily to quite low levels. The ultimate consequences of not taking moderate corrective action in good time might be to make a large-scale liquidation of bonds or undesirably drastic changes in lending policies, or both, unavoidable at some later stage. Moreover, the absence of any agreed minimum ratio of liquid assets would introduce another element of uncertainty concerning the response of the banking system to central bank action; it might be impossible to preduct even within quite wide limits the point at which banks as a group would feel they could no longer go on reducing their holdings of liquid assets.

48. A minimum liquid asset ratio, therefore, makes the response of banks somewhat more predictable and in addition it is likely to produce smoother reactions on their part. The banks are more likely to begin to take other steps gradually as their liquid assets approach the minimum rather than allow themselves to get into a position where they have no alternative but to

dispose of large blocks of securities and make major changes in lending policy.

49. It might, of course, be possible for banks as a group to react to a minimum liquid asset ratio by carrying a total of liquid assets far in excess of the require minimu, or by shortening their bond portfolios to the point where these holdings were themselves virtually liquid assets. If the banks were to do this when cash reserve conditions were easy, it might indeed become difficult when conditions tightened to predict when the banks would take action to adjust their lending policies. Normally, however, the desire of banks to maximize their earnings should prevent this excessive build-up of liquidity from occurring since the banks must sacrifice earnings in order to maintain excessive holdings of liquid assets whose yields tend to be relatively low. The central bank relies on competition for earnings in the financial system being keen enough to prevent any group of financial institutions from carrying excessive liquid reserves when there are opportunities for a more profitable use of their resources.

50. In Canada the minimum liquid asset ratio has, since 1956, been set by agreement with the chartered banks at 15 per cent of deposit liabilities on a monthly average basis. The liquid assets prescribed for the purposes of the ratio are cash reserves, day-to-day loans and treasury bills. It is the view of the Bank of Canada that the minimum liquid asset ratio is a useful instrument of monetary policy and that it should be retained.

C. Central Bank Advances and Bank Rate

Central Bank Advances

51. Standing arrangements under which the Bank of Canada is prepared, within specified limits and subject to certain terms and conditions, to respond to requests of chartered banks for temporary advances (and of money market dealers for temporary accommodation under securities purchase and resale agreements) play a rather limited but nevertheless useful role in the present system of monetary management. They provide individual banks and dealers with an underlying assurance of liquidity. Provided that arrangements for access to central bank credit are subject to adequate restrictions and involve paying a penalty rate of interest, they need not in practice appreciably weaken the central bank's control over the total of cash reserves.

52. In situations in which the Bank of Canada provides short-term accommodation to a bank or dealer, it might as an alternative make outright purchases of securities -- perhaps the same securities as those offered as collateral for advances or purchased under resale agreements. But arrangements which leave a certain amount of initiative in the hands of dealers and banks in increasing the supply of central bank cash may be quite useful, particularly if the central bank wishes to limit the extent of its direct participation in the securities market. In a system in which the central bank attempts to work largely through institutional and market responses to its cash reserve management, access to central bank credit by way of

advances and resale agreements provides a safety valve which prevents extreme responses to reductions in the total amount of cash reserves, or to an uneven distribution of cash reserves, or to sudden increases in the demand for bank credit. By letting banks and dealers take the initiative in dealing with a stringent cash reserve situation, the central bank may also in appropriate situations provide less relief to an atmosphere of "tightness" than if it took the initiative itself by appearing in the market as a buyer of securities.

53. Certain minimum conditions must be fulfilled if central bank lending is to play a role in the provision of cash reserves without undermining the basis of central bank control. The central bank must not be the cheapest source of credit in the market, or there will be no incentive for banks and dealers to seek to obtain their requirements elsewhere. Nor must the cost of central bank credit be too far above short-term market rates for if this were the case access to the central bank would not be used and would therefore not serve to moderate extreme responses to tight situations in the money market. Rules must be applied in regard to the term of advances if the central bank is to limit itself to the provision of credit for very short periods. Other rules are necessary to avoid a situation where every single request for accommodation by a bank or dealer involves a separate negotiation -- for example, rules which allow the borrower to rely on automatic access to credit up to certain specified amounts and

advances and resale agreements provides a safety valve which prevents extreme responses to reductions in the total amount of cash reserves, or to an uneven distribution of cash reserves, or to sudden increases in the demand for bank credit. By leaving banks and dealers take the initiative in dealing with a tight cash reserve situation, the central bank may in appropriate situations provide less relief in an atmosphere of "tightness" than if it took the initiative itself by appearing in the market as a buyer of securities.

53. Certain minimum conditions must be fulfilled if central bank lending is to play a role in the provision of cash reserves without undermining the basis of central bank control. The central bank must not be the cheapest source of credit in the market, or there will be no incentive for banks and dealers to seek to obtain their requirements elsewhere. [illegible] must the cost of central bank credit be too far above short-term market rates for if this were the case access to the central bank would not be used and would therefore not serve to moderate extreme responses to tight situations in the money market. Rules must be adopted in regard to the term of advances if the central bank is to limit itself to the provision of credit for very short periods, these rules are necessary to avoid a situation where every single request for accommodation by a bank or dealer involves a separate negotiation -- i.e. rules which allow the borrower to be [illegible] access to credit up to certain specified amounts and

subject to certain specified conditions.

54. The question also arises whether banks should be allowed access to central bank credit under the same terms as money market dealers. If a bank finds itself in a tight position it can obtain funds from money market dealers by calling day-to-day loans (if it has any) and the dealers can turn to the central bank for accommodation if necessary. The Bank of Canada has regarded it as desirable to leave the banks with incentive to use the money market rather than lean directly on the central bank. It could indeed be argued that banks do not need direct access to central bank credit at all since they have the alternative of calling day-to-day loans or selling securities. However, this argument does not take account of the fact that borrowing from the central bank is the quickest and surest way for a bank to obtain additional cash reserves on a temporary basis, that a bank may be short of money-market assets, and that market conditions may make the sale of bonds unusually difficult. The current arrangements under which the central bank extends credit take account of the foregoing factors by allowing for a certain amount of virtually "automatic" credit, by limiting its duration, and by differentiating to some extent between banks and dealers. The present arrangements under which advances are made are set out in the appendix to this memorandum.

Bank Rate

55. The minimum rate of interest at which the central bank makes advances is called the Bank Rate. As

already indicated it is desirable that the Bank Rate should normally be somewhat above other money-market rates -- the day-to-day loan rate and the treasury bill rate -- but not too far above. Since 1956 the bank of Canada's Bank Rate has been set at 1/4 of one per cent above the latest weekly average tender rate for 91-day Treasury bills. It is a matter for discussion whether this method of establishing the Bank Rate is preferable to a fixed Bank Rate which is changed from time to time. Some of the main considerations relating to these alternatives are set forth below.

(a) <u>A "flexible" Bank Rate system</u>

56. Under the general operating approach which the Bank of Canada prefers to follow, and which has been outlined in preceding paragraphs, a Bank Rate tied to a money-market rate has certain advantages. The Bank Rate automatically retains an appropriate relationship to other money-market rates and the central bank is able to use a process of successive approximation without being inhibited by the market expectations which might be generated when short-term market rates approached or went through a fixed Bank Rate. Adjustments to changes in interest rates outside Canada can take place promptly and smoothly without being complicated by the various considerations which arise when there is need to announce changes in the fixed Bank Rate.

57. On the other hand, it has been said that a Bank Rate which is tied to the treasury bill rate and therefore changes each week does nothing to lend stability to the market, or to change expectations in the

market when this is considered appropriate and might be achieved through the announcement of a clear-cut change in the Bank Rate. To this, the rejoinder might be that a flexible Bank Rate system reflects the tentative way in which the central bank usually proceeds and that a movement of the flexible Bank Rate to a level that is clearly different from that which has prevailed in the recent past can provide the market with an indication of the central bank's view, not in the dramatic way but perhaps as clearly as is normally reasonable to expect.

(b) A "fixed" Bank Rate system

58. A system in which the Bank Rate is not tied to a money-market rate and is changed infrequently would appear to fit in best with an approach under which the central bank seems to influence interest rates more directly than by management of the cash base; but it is nevertheless still compatible with an approach which is largely indirect. With a given Bank Rate money-market rates could move up or down within a certain range and when a new band of short-term rates came to be regarded as more appropriate to the current circumstances the Bank Rate would be changed. Since the fixed Bank Rate would still be set on a tentative basis there is in principle no reason why it should inhibit the central bank from permitting or encouraging market rates to move, although it is only realistic to recognize that in practice it probably would be inhibiting on occasion. If there were quite frequent changes in the Bank Rate there would indeed be rather little difference between

[illegible] larger [illegible] of a [illegible] change in the bank rate. To this, [illegible] might [illegible] a [illegible] Bank [illegible] [illegible] the [illegible] in which the central bank [illegible] [illegible] movement of the [illegible] Bank [illegible] [illegible] [illegible] in [illegible] from the [illegible] in the recent past [illegible] [illegible] the [illegible] of the central bank's view, [illegible] as [illegible] as it normally [illegible] of [illegible].

(b) A [illegible] Rate Policy

73. A [illegible] in which the Bank Rate is not [illegible] [illegible] rate and is changed [illegible] [illegible] appear to fit in one, which [illegible] [illegible] the central bank [illegible] [illegible] more directly than by management [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]. What [illegible]

[illegible] it is only [illegible] [illegible] [illegible] [illegible] probably would [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]

the fixed and flexible systems. However, if a desired feature of the system were that changes should not be frequent and that they should reflect a definite change in the views of the authorities the problem would become more difficult. Under such a system a fixed Bank Rate would tend not to be changed unless those responsible felt quite sure that such a change would be desirable, and one likely consequence might be that changes in Bank Rate would be delayed until there was much more certainty regarding the need for a change than would be required for smaller, more tentative changes. The timing of changes in a fixed Bank Rate might well, therefore, display an undesirable lag. The fact that Canadian interest rares are affected so much by movements in United States interest rates would raise special problems in maintaining a Bank Rate unchanged for extended periods.

59. A fixed Bank Rate might lend an element of stability to money market rates by tentatively placing an upper limit on their movement. On the other hand, market conditions might become unstable for a time when changes in the Bank Rate were anticipated or if an unexpected change in the Bank Rate were made. By changing the fixed Bank Rate the central bank might be able to bring about a substantial change in market expectations on the infrequent occasions when it wished to draw attention in a rather dramatic way to a marked change in the economic and financial climate. The difficulty would be, however, that on the more usual occasions when no such marked change in the economic out-

the fixed and flexible systems. However, [illegible] features of the system were that [illegible] changes should be [illegible] and that they should not be [illegible] with the rates of the currency at the point [illegible] become more difficult. [illegible] would have would find [illegible] [illegible] [illegible] nd, or [illegible] [illegible] [illegible] which [illegible] [illegible] 8 [illegible] would be [illegible] the [illegible] fixing of changes in a fixed [illegible] therefore, [illegible] [illegible]

[illegible]

59. A fixed [illegible]

of stability [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] the fixed [illegible]

[illegible] in a [illegible] [illegible] in the [illegible] [illegible] would be [illegible]

look had occurred but a change in the Bank Rate was necessary simply to keep it in line with slowly evolving credit conditions, the change might be misinterpreted and have an undesired impact on market expectations. If the central bank wished to indicate definite views to the market regarding the financial or economic situation it could of course do so by making public statements, whatever Bank Rate system was being used.

60. In some countries changes in the Bank Rate are accompanied by changes in a variety of institutional lending and deposit rates, in accordance with some agreed convention. Arrangements of this character would make the central bank's influence on credit conditions more immediately pervasive, but they would also involve it more directly in influencing interest rates of particular credit institutions.

61. Even though changes in a fixed Bank Rate appear to raise monetary policy issues in a somewhat crude and arbitrary way, since the timing and magnitude of such changes are usually only imperfect indicators of the constantly shifting emphasis of policy, it can be argued that they do nevertheless bring into focus at the time they occur the monetary policy which is being followed in a way which does not occur under the flexible rate system.

62. The Bank continues to have under review alternative methods of determining and using the Bank Rate. As stated in his Annual Report for 1961, the Governor hopes and expects that the views of interested parties will be made known in evidence before the Royal

Commission, and his present intention is to keep an open mind on the matter until all those with a major interest in it have had a chance to express their opinions.

D. Variable Minimum Cash Reserve and Liquid Asset Ratios

63. The power to vary the minimum requirements for cash reserves places the central bank in a position where it can impound or release chartered bank liquidity. This power would also be implied in any procedure which enabled the central bank to vary the liquid asset ratio. The major difference between a variable cash reserve ratio and a variable liquid asset ratio is the effect on bank earnings, since cash reserves are non-earning assets.

64. In situations where the central bank is using its normal techniques of cash management in order to exert a restraining influence on excessive demands for credit the chartered banks are likely to find it necessary to sell Government securities if they wish to continue increasing their loans. The expansion of bank loans is this likely to put strong upward pressure on market interest rates, and this will have a deterrent effect on borrowing through the sale of securities. But for reasons which have been explained in a previous submission there are limits to the extent to which the restraining mechanism of interest rate increases can be relied on in practice. In situations where further restraint is highly desirable but serious concern is felt regarding the high level of interest rates or the rapidity of their upward movement, there may be a strong case for the central bank invoking supplementary techniques which it would be reluctant to use in less pressing circumstances. By using one of the devices mentioned above to impound part of the chartered banks'

remaining liquid resources, the central bank could reduce the ability of the chartered banks to continue financing loan expansion through sales of securities, and thus make it necessary for them to begin rationing their loans more stringently and sooner than they might otherwise have done. The effect would be to reduce the availability of credit without significant additional upward pressure on interest rates.

65. Such a policy would not succeed in accomplishing much if the unsuccessful applicants for bank credit merely turned up elsewhere in the market to press their demands for credit. However, there are substantial imperfections and much inertia in credit markets and it is a reasonable assumption that many of the disappointed bank borrowers would either fail to search out and find alternative sources of credit or would be deterred at least in part from pressing their full demands through unwillingness to accept stiffer credit terms.

66. Because liquidity-control techniques are designed to take advantage to some extent of the existence of imperfections in credit market, it is probable that they cannot be used for very long without new market channels developing which reduce their effectiveness. They also have the disadvantage of being discriminatory if they apply only to banks. In the ordinary course of events it should not be necessary to use devices of this kind: monetary, fiscal, debt management and other public economic policies should be able to exert a strong enough influence on economic

reduce the ability of the commercial banks to [illegible] financing loan expansion through sales of government [illegible], and thus make it necessary for them to obtain reserves [illegible]

occurring [illegible] more. The effect would be to [illegible] the availability of credit, restrain [illegible] and pressure on interest rates.

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[illegible] required to take advantage to some extent of the [illegible] [illegible] [illegible] in [illegible] [illegible] [illegible] [illegible] been [illegible] used for many [illegible] [illegible] [illegible] [illegible] which [illegible] [illegible] [illegible] [illegible] [illegible] the [illegible] [illegible] [illegible], if they [illegible] own, [illegible] and [illegible] [illegible] of [illegible] [illegible] [illegible] [illegible] of this [illegible] [illegible] [illegible] and other public [illegible] [illegible] [illegible] a [illegible] [illegible] [illegible]

conditions. It is only realistic to recognize, however, that exceptional situations may arise in which these policies taken together fail to cope with the situation, and in which it may be preferable to fall back on such techniques rather than permit major economic damage to be inflicted.

E. Moral Suasion

67. The term "moral suasion" has long been used in connection with central banking in referring to a wide range of possible initiatives by the central bank designed to enlist the co-operation of commercial banks or of other financial organizations in pursuit of some objective of financial policy. The term is rather imprecise. In some contexts it may refer merely to general exchanges of views with the banks or others aimed at improving mutual understanding and awareness of the current financial situation, of the general objectives of financial policy, or of particular problems which have arisen in the operation of financial markets and institutions. In other contexts, the term is used to mean efforts by the central bank to achieve, through suggestion, discussion and persuasion, specific changes -- sometimes temporary -- in policies or practices of private financial organizations. It is difficult, therefore, to generalize about either the nature or the effectiveness of moral suasion.

68. The Bank of Canada has a clear responsibility to do what it can to promote mutual understanding of how its operations impinge on those of the financial system, and one means of doing this is for the Bank to have frequent and close contact with chartered banks and other financial organizations. One of the continuing interests and responsibilities of the Bank is to improve the organization and operation of financial markets in Canada and in order to achieve this, frequent discussion with other participants in financial

B. Moral Suasion

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markets is essential. Many such discussions with regard to particular financial practices in which the Bank has participated have resulted in agreement on new proposals which have subsequently been implemented. Perhaps the outstanding example is the series of innovations and changes which permitted the growth of a short-term money market in Canada. The Bank of Canada regards the kind of leadership that it was able to give in the development of the money market as a constructive use of moral suasion.

69. In general, moral suasion would seem to work best when it involves leadership and exhortation directed toward goals that involve no essential conflict between public and private interest and where co-operation is therefore likely to be readily forthcoming. In other forms, however, it may have important drawbacks. Where targets can be established against which performances can be reviewed -- as, for example, an agreement with the chartered banks to observe some over-all loan ceiling -- this technique may well be effective but it is likely to involve some loss in flexibility of the financial system or some reduction in competition. It may also involve discrimination in favour of other groups of lenders who do not respond to moral suasion. If what is sought is to change the distribution of credit, it must be said that there is an important area of doubt regarding the propriety of the central bank making qualitative decisions about the allocation of credit to particular classes of borrowers or for particular purposes unless it is clear that the central bank is operating on

efforts is essential. Many such [illegible] with [illegible] or particularly financial programs [illegible] that has participated have resulted in agreement [illegible] new proposals which have subsequently [illegible] the outstanding example [illegible] [illegible] and changes which [illegible] the [illegible] money market [illegible]. The [illegible] [illegible] the kind of leadership that [illegible] was [illegible] the development of the money market as [illegible] [illegible] institution.

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behalf of the Government. Another problem in moral suasion is that of the timing of disengagement from the understandings reached: the withdrawal of a suggestion regarding policies to be followed runs the risk of being interpreted as meaning that the central bank wishes to see a considerable change in existing policies without this necessarily being the case.

70. In general the Bank of Canada is reluctant to ask financial organizations to act in a manner contrary to that indicated by the market forces which confront them; and it prefers whenever possible to discharge its responsibilities through the use of its normal cash reserve management techniques. However, the Bank is aware that there may be occasions when ordinary procedures are not adequate and in which exceptional requests for co-operation should be made.

APPENDIX

The Control of Chartered Bank Cash Reserves by the Bank of Canada

71. The Bank Act requires each chartered bank to carry a minimum monthly average cash reserve amounting to 8 per cent of its Canadian dollar deposit liabilities in the form of notes of and deposits at the Bank of Canada. By varying the amount of cash available to the system the Bank of Canada can, over time, regulate the broad trend of the chartered banks' total deposit liabilities in a manner consistent with the changes in credit conditions which it considers appropriate in the circumstances. This memorandum describes the ways in which the cash reserves of the banks may be changed.

72. In operating a system where the minimum cash reserve requirement is expressed as a percentage of deposit liabilities it is necessary to have information on each of the three elements that enter into the calculation of the ratio. Statistics of deposit liabilities and of banks' holdings of Bank of Canada notes must be compiled from the returns of individual bank branches and for this reason are available only with some time lag. The Bank Act prescribes that for purposes of calculating the required legal reserve, the deposit and note holdings relevant for each month should be taken as the average amounts on the four consecutive Wednesdays ending with the second last Wednesday of the previous month. The other component of the cash reserve, deposits with the Bank of Canada, is calculated by averaging the daily figures for the current month.

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Under this method of determining the reserve requirement, two of the elements are fixed at the beginning of each month, and satisfaction of the law requires only that each bank's monthly average deposit with the Bank of Canada shall not fall short of the indicated minimum level. Changes in deposit liabilities and in banks' holdings of notes do not affect the legal reserve calculation until the beginning of the next month. For the sake of simplicity, the following comments on changes in chartered bank cash reserves refer only to changes in their deposits at the Bank of Canada, that is, to changes in cash reserves within the month.

73. In general, changes in total chartered bank deposits at the central bank result from the balance of changes in all other Bank of Canada assets and liabilities. Some of the factors affecting the level of reserves are under immediate central bank control while others are not. Since, however, the Bank is within reasonable limits aware of changes in those factors which it cannot control directly, it is generally able to take account of them in deciding what its own action should be.

74. The most important asset held by the Bank of Canada is its portfolio of Government of Canada securities: at May 31, 1962 the Bank held $2,824 million of Government securities and $325 million in other assets. Changes in its portfolio effected by purchases and sales of securities in the market and by purchases of new securities provide the Bank of Canada with its most important means of influencing the level of cash

[illegible]

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75. The most important single factor [illegible] reserves is the purchase or sale of government [illegible]

[illegible]

[illegible] Government securities [illegible] million [illegible]

[illegible]. Changes in the Bank's holdings [illegible] sales of securities in the market [illegible] new securities [illegible] the [illegible] principal means of [illegible]

reserves. If the Bank purchases securities from a chartered bank it makes payment by issuing a cheque on itself which the chartered bank returns for credit to its deposit account at the Bank of Canada. Conversely, sales of securities by the Bank of Canada to a bank will result in payment by cheque drawn on that bank's deposit account with the Bank of Canada. In the case of a purchase from someone other than a bank, the Bank of Canada cheque issued in payment will be presented by the seller for credit to his own account with a chartered bank or other financial institutions, and then returned to the Bank of Canada for credit to the deposit account of one of the banks. Thus, whoever the seller of the security may be, payment by the Bank of Canada takes the form, after clearings and final settlement, of an increase in the deposit account of one of the banks, that is to say, an increase in the reserves of the banking system. The Bank of Canada does not ordinarily know which bank will gain reserves. It acts to increase the amount of cash available to the system as a whole and the share obtained by each bank depends on the competition between banks for business.

75. Transactions in securities with the Government, whether at the time of new issues, in the course of trading in outstanding securities with Government accounts, or at the maturity of issues held in the Bank of Canada's ½ortfolio have the same effect on bank reserves as transactions with banks or with the puboic. Purchases from the Government result in the first instance in increases in the Government's balances

with the Bank, but on redeposit of the balances with chartered banks (a matter to be discussed below) the banks come into possession of additional claims on the Bank of Canada and cash reserves increase. Conversely, when the central bank sells securities to the Government or allows them to run off at maturity, it receives payment by a reduction of its deposit liabilities to the Government and, after transfer of the necessary amounts from Government balances with the chartered banks, by a reduction in bank reserves. The Bank of Canada has an opportunity each week at the treasury bill tender to adjust chartered bank cash reserves by bidding in a way designed to vary its holdings in the direction and amount desired though the Bank cannot be sure that it will accomplish its objective. Changes in the total of Government securities held by the Bank may be made to bring about changes in reserves or to offset other factors which would have altered the level of reserves.

76. The Government of Canada maintains a deposit account with the Bank of Canada through which pass virtually all Government receipts and payments. If this were the only Government bank balance it would fluctuate with the daily ebb and flow of Government receipts and payments. In periods when the Government was on balance receiving more in tax and other revenues than it was paying out in the course of its business, it would be receiving cheques on banks and other institutions for credit to its account and after settlement the deposits of the chartered banks would be reduced. In the opposite case Government cash balances

with the Bank, but on redemption of the balances with [illegible]

banks come into possession of additional claims on the Bank of Greece and their reserves increase. Conversely, when the central bank sells securities to the Government or allows them to run off at maturity, it receives payment by a reduction of its deposit liabilities to the Government and, after transfer of the necessary amount from Government balances with the commercial banks, by a reduction in bank reserves. The Bank of Greece can, by offering each week at the treasury bill tender an [illegible] bank reserves by bidding, in a [illegible] or vary its holdings in the direction and amount desired though the Bank cannot be sure that it will accomplish its objective. Changes in the total of Government securities held by the Bank may be made to bring about changes in reserves or to offset other factors which would have altered the level of reserves.

70. The Government of Greece maintains a deposit account with the Bank of Greece, through which pass virtually all Government receipts and payments. If this were the only Government deposit, it would [illegible] with the [illegible] and flow of Government receipts and payments. In practice, the Government [illegible] in tax and other receipts when it was paying out in the course of its business. It would be [illegible] on [illegible] [illegible]

would be running down while the balances of chartered banks would be increasing. Thus cash reserves would tend to fluctuate sharply in consequence of the uneven flow of Government payments. In order to avoid this sort of disturbance the Government maintains deposit balances with the chartered banks as well as with the central bank and permits the Bank of Canada, with the concurrence of the Minister of Finance, to transfer balances between the Bank and the chartered banks. (The share of deposits placed with each bank is determined by a formula agreed among the banks which takes account of a number of factors). So long as balances are transferred in amounts such that all of the changes in the Government's total cash balances occur in its balances at chartered banks and the account at the central bank is held steady, the flow of Government payments will not affect cash reserves. The Bank of Canada normally follows this practice and in this manner offsets the potential effect on cash reserves of Government revenue and expenditure. In order to assist in the day-to-day management of chartered bank cash reserves the level of the Government's balance at the central bank may be varied within a moderate range but does not go outside this range frequently or for long.

77. These are arrangements which leave some initiative in the hands of banks and dealers in increasing the cash reserves. When a bank finds itself suffering cash losses it seeks to regain cash and adjust its position by liquidating its more liquid assets. Normally it will start the adjustment by calling some

[illegible] by increasing. The cost [illegible] would

[illegible] to increase agency in consequence of the [illegible]

The [illegible] Government argument. In [illegible]

[illegible] Government [illegible]

[illegible]

[illegible] to the [illegible] of [illegible]

[illegible]

of its day-to-day loans to money market dealers and, concurrently or perhaps a little later, it will sell treasury bills and other short-dated securities out of its portfolio. By so doing the bank will draw cash to itself at the expense of other banks: there would at this stage be no increase in aggregate reserves. However, if the dealers whose day-to-day loans have been called are unable to find alternative financing from other banks or elsewhere and are unwilling or unable to balance their positions by selling securities, they may do so by selling securities to the Bank of Canada under an agreement to repurchase them some time within a maximum period of thirty days. Such transactions temporarily increase cash reserves for the period during which the Bank of Canada holds the securities. The price at which securities are resold to the dealer is such that he pays a charge equivalent to Bank Rate for the accommodation. Each money market dealer is entitled to use this facility up to an agreed limit related to the volume of his business. In 1961 the Bank of Canada held securities under "Purchase and Resale Agreements" on 55 business days. The maximum amount outstanding on any one day was $93 million and the daily average for the year was $3 million.

78. The chartered banks may also obtain additional reserves for short periods by borrowing directly from the Bank of Canada. The present arrangements under which such advances may be obtained are designed to limit the Bank's role as lender of last resort to exceptional circumstances and to encourage the

chartered banks to use, whenever practicable, alternative methods of adjusting their cash reserves in the market such as calling day-to-day loans or selling securities. Advances are made for a minimum period of seven days against the hypothecation of suitable securities. The first advance made to a bank in any calendar month (up to a certain amount specified for each bank) bears interest at the Bank Rate, the minimum rate at which the central bank makes advances. A second advance to the same bank in any calendar month, or a renewal of an advance, or an advance in excess of the specified amount, bears interest at a rate higher than the Bank Rate.

79. In 1961 Bank of Canada advances to chartered banks and Quebec Savings Banks were outstanding on 10 business days. The maximum amount outstanding on any one day was $11 million and the daily average for the year was $0.2 million. Thus advances were a less important source of temporary cash than were Purchase and Resale Agreements, and the two together provided only a very small fraction of the required reserves of the chartered banks during the year.

80. To encourage banks and money market dealers to try to meet their requirements in the market before coming to the Bank, the Bank Rate is normally kept above the day-to-day loan and 91-day treasury bill rates. Since November 1956 it has been set ¼ of 1 per cent above the average successful rate at the most recent tender for 91-day treasury bills.

81. The Bank of Canada carries assets and

[illegible] accrued wages to date, whenever [illegible]

methods of adjusting their [illegible]

such as [illegible]; loans or [illegible].

Advances are made for a [illegible] period or [illegible]

against the [illegible]

[illegible] in any [illegible]

[illegible] certain amount [illegible] for each [illegible]

[illegible] New York State, the [illegible]

[illegible]

to [illegible] any [illegible] month, [illegible]

on an advance, or an advance in excess of [illegible]

amount, [illegible] interest at a rate [illegible]

State.

9. [illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

liabilities in foreign currencies. The liability is principally to the Government and the bulk of the asset is simply the counterpart of this liability. The difference between foreign currency assets and liabilities is normally quite small (for some years it has been about $10 million) and represents the foreign exchange held for the Bank's own account. This net position in foreign currencies does not vary significantly, reflecting the fact that the Bank of Canada does not operate in foreign currencies for cash management purposes.

82. The largest liability of the Bank of Canada is the amount of notes in circulation, which includes notes held by the banks as well as those in the hands of the general public. The Bank does not control the amount of the note circulation. It is able to influence only the combined total of currency and chartered bank deposits and does not determine the proportion which the public holds in the form of Bank of Canada notes; this is determined by the public in response to its varying need for notes for the making of payments. As the public withdraws notes by drawing on its deposits at chartered banks, the banks in turn may replenish their till money by drawing down their deposits at the Bank of Canada. Thus during each month changes in the total note circulation alter bank reserves by an equal amount, increases in the note circulation reducing reserves and vice versa. The note circulation is subject to a strong seasonal movement, building up to a peak during the Christmas shopping

liabilities in foreign currencies. The liability is principally to the Government and the [illegible] of the [illegible] is simply the counterpart of this liability. The difference between foreign currency assets and liabilities is normally quite small (for some years it has been about $1 million) and represents the foreign currency [illegible] for the bank's own account. That net position in foreign currencies does not vary significantly. [illegible] the fact that the Bank of Canada does not operate in foreign currencies for bank management purposes.

62. The largest liability of the Bank of Canada is the amount of notes in circulation, which includes notes held by the banks as well as those in the hands of the general public. The bank does not control the amount of its note circulation. It is able to influence only the combined total of currency and chartered bank deposits and leaves this [illegible] proportion which the public holds in the form of [illegible] amount of this is determined by the public in response to its varying need for notes [illegible] the public withdraws notes [illegible] the banks [illegible] their holdings [illegible] at the Bank of Canada. When [illegible] changes in the total note circulation [illegible] offset by an equal amount [illegible] circulation, reducing reserves [illegible] circulation is subject to a strong seasonal movement, [illegible] up to a peak during the [illegible]

period and then falling off sharply at the beginning of the year. This regular swing is one of the most important influences operating on the cash reserves. The main way in which the Bank of Canada can offset the effect of changes in note circulation on cash reserves is by transactions in Government securities, though the transfer of the Bank's profits to the Government in December is also important in this connection. The relationship between note circulation and the Bank's securities operations is brought out clearly in the attached chart of Bank of Canada accounts.

83. The Bank of Canada makes funds available to its subsidiary, the Industrial Development Bank, by acquiring its shares, bonds and debentures. Purchases of these assets increase chartered bank reserves in the same manner as purchases of Government securities.

84. The Bank of Canada operates Canadian dollar deposit accounts for a number of clients in addition to the Government and the chartered banks. These accounts, which include deposits of the Quebec Savings Banks and of foreign central banks, are shown as a single liability item on the Bank of Canada balance sheet. This item does not fluctuate much and is not used for cash management purposes.

85. Bank of Canada profits accumulate during the year as interest on the portfolio of Government securities and other much smaller earnings items are received, and profits are paid over to the Government towards the end of each year. The receipt of interest earnings from the Government draws down bank cash while

period and then falling off sharply at the beginning of the month. This regular [illegible] in the [illegible] important influences operating on the cash reserves, [illegible] the Bank of Canada [illegible] the effect of changes in note circulation [illegible] by transactions in [illegible] [illegible] of the Bank's policies to the [illegible] become of less important in [illegible]. The [illegible] between note circulation and [illegible] [illegible] operations in [illegible] attention [illegible] of Bank of Canada [illegible].

9. The Bank of Canada [illegible] the [illegible] the Dominion [illegible] [illegible] of [illegible] [illegible] bonds and [illegible]. [illegible] [illegible] [illegible] the same manner as purchases of [illegible].

10. The Bank of Canada [illegible] [illegible] deposit accounts for [illegible] [illegible] the government and the [illegible] [illegible] accounts, [illegible] [illegible] [illegible] [illegible] [illegible].

11. [illegible] of Canada [illegible]

[illegible] greater interest on the [illegible] [illegible] much smaller [illegible] and [illegible] are paid [illegible] the end of each year. The [illegible] [illegible] from the Government [illegible]

remittance of profits increases the reserves: The Bank of Canada must take this cycle into account in determining cash management policy. The third line on the chart of Bank of Canada accounts entitled 'other assets less other liabilities' includes the profits accounts and reflects the annual build-up of this liability item, as well as its discharge towards the end of the year.

86. This same line includes the net amounts of Bank of Canada transactions which were in transit on reporting days. Virtually all transactions of the Bank, including those for the accounts of the Government and other clients, are cleared and settled against the relevant accounts on the day following receipt of cheques at Bank of Canada agencies, whether the payment is due to or due by the Bank. The amount of float, reflecting the process of settlement of prior transactions is, therefore, known to the Bank at least one day before its effect on cash reserves and may be taken into account in cash management.

[illegible] amount of profits increases the reserve. The Bank of Canada must make this cycle in an amount [illegible] [illegible] monetary policy. The third line [illegible] Bank of Canada accounts entitled "Other assets" and other liabilities' indicates the [illegible] and reflects the annual build-up of these [illegible] as well as the discharge towards the end of the year.

88. This same line includes the net amount of Bank of Canada transactions with [illegible] on depending days. Normally all transactions of the Bank, including those for the accounts of the Government and other clients, are cleared and settled [illegible] current accounts on the day they take place [illegible] accounts at Bank of Canada agencies, [illegible] is due to or due by the Bank. The amount [illegible] reflecting the process of settlement [illegible] [illegible], therefore, known [illegible] any [illegible], affects [illegible] reserves [illegible] [illegible] in cash management.

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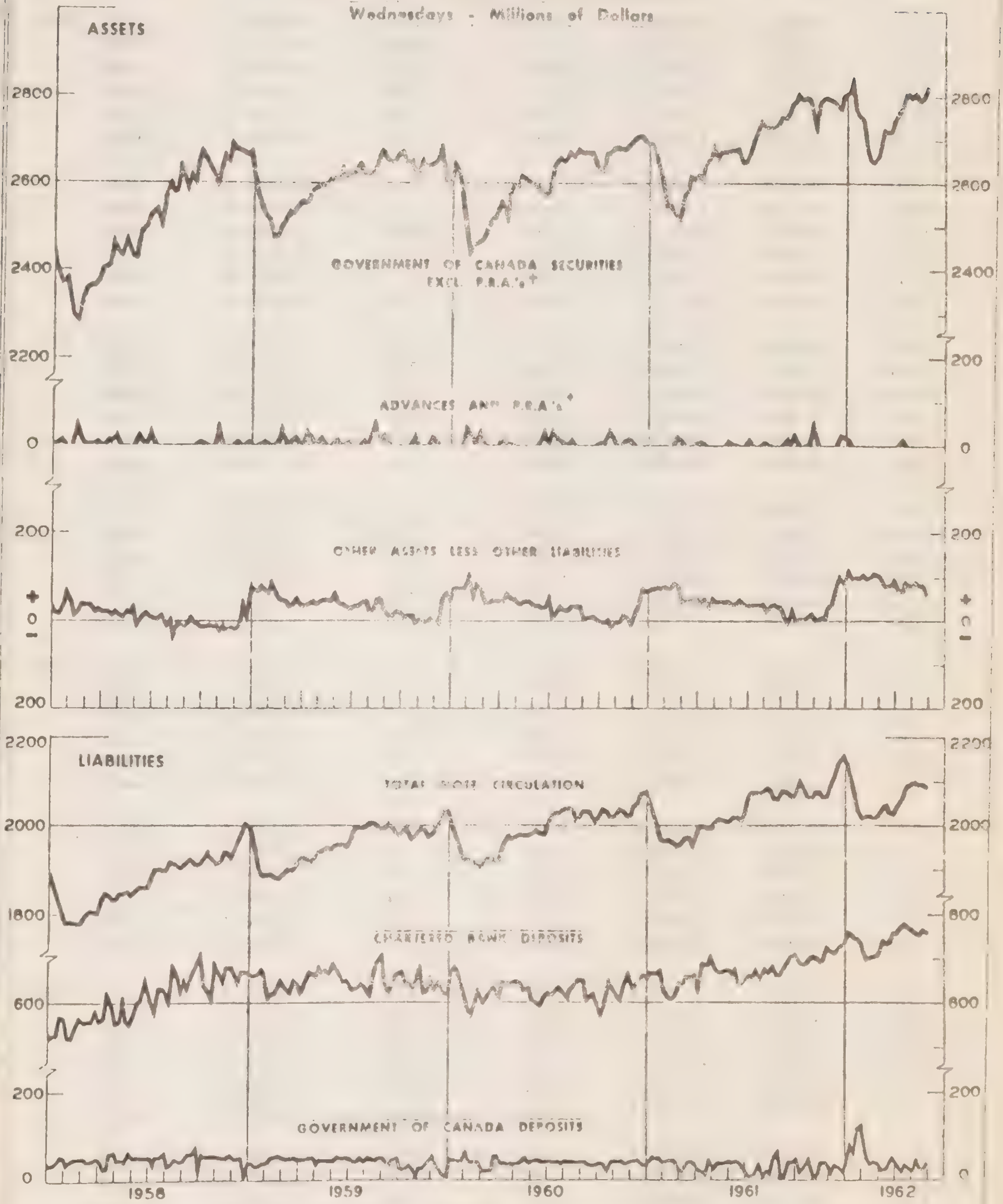
BANK OF CANADA ACCOUNTS
Wednesdays - Millions of Dollars



† Securities purchased from money market dealers under resale agreements

LAST DATE PLOTTED MAY 30
31/5/62

BANK OF CANADA ACCOUNTS
(Average of Wednesdays - millions of dollars)

	Assets			Liabilities		
	Gov't. of Canada Securities ex. P.R.A.'s	Advances and P.R.A.'s	Other Assets Less Other Liabs.	Total Note Circulation	Chartered Bank Deposits	Gov't. of Canada Deposits
1957 - Dec.	2,453.6	7.8	5.8	1,874.2	542.9	50.1
1958 - Jan.	2,384.5	3.1	32.0	1,836.8	540.9	41.9
Feb.	2,317.9	12.8	29.2	1,781.1	536.1	42.6
Mar.	2,376.5	1.9	29.8	1,801.4	560.9	46.0
Apr.	2,428.1	9.0	17.5	1,834.8	577.3	42.5
May	2,441.4	0.3	18.4	1,846.3	565.8	47.9
June	2,490.3	18.7	6.9	1,858.2	606.7	51.1
July	2,557.9	-	1.5	1,897.1	613.5	48.7
Aug.	2,601.0	-	-16.3	1,909.8	637.0	38.0
Sept.	2,632.1	0.8	- 4.9	1,916.8	655.9	55.3
Oct.	2,624.5	6.8	-12.7	1,921.4	650.1	47.2
Nov.	2,668.9	-	-20.3	1,930.3	666.8	51.5
Dec.	2,659.5	2.1	15.5	1,977.8	660.6	38.7
1959 - Jan.	2,547.9	0.8	72.1	1,924.0	663.9	32.9
Feb.	2,489.7	9.5	62.8	1,886.6	626.5	48.9
Mar.	2,539.5	7.1	39.8	1,900.8	636.2	49.4
Apr.	2,573.3	9.2	38.1	1,923.4	649.7	47.5
May	2,603.5	3.5	44.7	1,944.1	668.2	39.5
June	2,617.4	3.0	42.5	1,952.8	661.8	48.5
July	2,626.1	2.4	35.9	1,988.6	631.7	44.0
Aug.	2,651.3	25.8	35.2	1,999.0	666.5	46.8
Sept.	2,658.8	0.6	18.3	1,990.1	645.2	42.4
Oct.	2,636.3	4.3	5.9	1,982.7	639.6	24.1
Nov.	2,643.0	3.8	0.2	1,982.7	642.2	22.1
Dec.	2,629.2	1.5	31.7	2,011.6	626.9	23.8
1960 - Jan.	2,589.8	-	70.6	1,961.3	657.5	41.6
Feb.	2,455.5	20.5	77.2	1,913.6	594.2	45.4
Mar.	2,526.1	0.1	44.2	1,920.5	617.2	32.7
Apr.	2,572.2	5.9	51.0	1,961.3	633.0	34.8
May	2,607.0	-	42.8	1,974.8	635.7	39.4
June	2,585.2	7.5	36.1	1,983.5	605.4	39.8
July	2,649.8	16.6	19.8	2,024.6	623.1	38.6
Aug.	2,668.6	2.2	28.7	2,025.5	634.0	40.1
Sept.	2,655.1	-	5.7	2,022.4	605.5	32.9
Oct.	2,659.2	14.1	- 5.7	2,026.5	609.1	32.1
Nov.	2,684.8	6.4	0.5	2,025.6	627.9	38.2
Dec.	2,699.7	-	45.7	2,059.3	650.4	35.6
1961 - Jan.	2,649.7	-	72.2	2,011.1	665.2	45.6
Feb.	2,535.1	4.3	75.6	1,959.2	616.0	39.7
Mar.	2,600.1	2.0	45.5	1,968.5	650.0	28.9
Apr.	2,649.5	1.7	41.5	1,994.4	675.2	23.2
May	2,668.8	1.5	41.3	2,011.5	666.3	33.9
June	2,663.6	0.2	38.8	2,017.1	653.0	32.6
July	2,705.8	2.8	36.1	2,067.4	663.9	13.4
Aug.	2,735.1	0.5	31.5	2,070.2	667.7	29.2
Sept.	2,772.0	9.2	4.6	2,071.5	692.0	22.3
Oct.	2,795.8	0.8	6.9	2,079.3	689.6	34.7
Nov.	2,775.8	9.0	9.2	2,067.4	702.0	24.5
Dec.	2,785.2	10.1	71.4	2,124.6	719.7	22.3
1962 - Jan.	2,781.9	2.8	102.7	2,068.9	746.0	73.4
Feb.	2,661.5	-	102.8	2,020.1	702.6	41.3
Mar.	2,727.2	-	83.8	2,03[illegible].9	740.4	34.7
Apr.	2,788.3	2.3	77.4	2,071.3	768.1	28.6
May	2,803.7	-	78.2	2,092.5	759.5	29.9

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BANK OF CANADA

STATEMENT OF ASSETS AND LIABILITIES

AS AT May 31st, 1962

ASSETS—

1. Gold Coin and Bullion		$	
2. Foreign Exchange—			
(a) Pounds Sterling and U.S.A. Dollars	$ 43,227,437		
(b) Other Currencies	131,690		
Total		43,359,127	
3. Bills Discounted			
4. Advances to—			
(a) Government of Canada			
(b) Provincial Governments			
(c) Chartered and Savings Banks			
Total			
5. Bills Bought in Open Market, Not Including Treasury Bills			
6. Investments—			
(a) Treasury Bills of Canada	222,171,331		
(b) Other securities issued or guaranteed by Canada maturing within two years	496,248,983		
(c) Other securities issued or guaranteed by Canada not maturing within two years	2,105,370,094		
(d) Securities issued or guaranteed by a province of Canada			
(e) Bonds and debentures issued by Industrial Development Bank	105,562,906		
(f) Other securities	26,079,119		
Total		2,955,432,433	
7. Industrial Development Bank—			
Total Share Capital at cost		29,000,000	
8. Bank Premises		10,638,047	
9. All Other Assets		111,005,860	
Total		$ 3,149,435,467	

LIABILITIES—

1. Capital Paid Up		$ 5,000,000
2. Rest Fund		25,000,000
3. Notes in Circulation		2,082,620,589
4. Deposits—		
(a) Government of Canada	$ 48,074,057	
(b) Provincial Governments		
(c) Chartered Banks	762,188,936	
(d) Other	51,543,813	
Total		861,806,806
5. Liabilities Payable in Pounds Sterling, U.S.A. Dollars and Other Foreign Currencies—		
(a) To Government of Canada	43,510,104	
(b) To Others	14,717,247	
Total		58,227,351
6. All Other Liabilities		116,780,721
Total		$ 3,149,435,467

Maturity Distribution of Investments in Securities Issued or Guaranteed by Canada not Maturing Within Two Years (see item 6(c) of above assets).

(a) Securities maturing in over 2 years but not over 5 years	$ 495,399,697
(b) Securities maturing in over 5 years but not over 10 years	$ 419,815,596
(c) Securities maturing in over 10 years	$ 1,190,154,801
	$ 2,105,370,094

Total Amount of Securities Included in Items 6 (a), (b) and (c) of Above Assets Held Under Purchase and Resale Agreements .... $ -

Submission by the Bank of Canada to the
Royal Commission on Banking and Finance

May 31, 1962.

IV - THE ROLE OF THE BANK OF CANADA IN DEBT MANAGEMENT

May 31, 1962.

IV - THE ROLE OF THE BANK OF CANADA IN DEBT MANAGEMENT

A. Introduction

1. In the context of this submission debt management is taken to mean the management of that part of the Government of Canada's debt which takes the form of direct and guaranteed securities outstanding. (There are of course various financial claims other than securities outstanding which might be included in the Government's gross debt, as well as a variety of financial and physical assets owned by the Government which might be deducted in computing its net debt; these are largely irrelevent, however, to the matters discussed in this memorandum). It includes the determination of the detailed characteristics of new issued, arrangements for their marketing and servicing, and the operation of certain Government investment accounts.

2. The responsibility for debt management lies with the Government. The Bank of Canada's role in this field is that of fiscal agent (Section 20(2) of the Bank of Canada Act provides that: "The Bank of and when required by the Minister so to do, shall act as agent for the Government of Canada in the payment of interest and principal and generally in respect of the management of the public debt in Canada." At the request of the Government the Bank of Canada absorbed the Loans and Interest Branch of the Department of Finance in May 1938 and assumed responsibility for the detailed servicing of and accounting for the outstanding

Government debt.) and adviser, and since the Bank is a source of information and advice and carries out certain functions in this field on behalf of the Government it has been thought desirable to include a memorandum on this subject in the Bank's submissions.

3. Before the Bank's servicing and advisory functions in debt management are described in detail it may be useful to refer to some of the major considerations and problems involved in the management of the Government debt, including its impact on credit conditions and the necessarily close relationship between debt management and monetary operations.

Government debt.) and advises, and since the Bank [illegible]

a source of information and advice and [illegible]

certain functions in this field on behalf of the

Government it has been thought desirable to [illegible]

comments on this subject in the Bank's own [illegible]

5. Before the Bank's servicing and [illegible]

efforts in debt management are described [illegible]

may be useful to refer to some of the major considera-

tions and problems involved in the management of

Government debt, including its impact on credit

conditions and the necessarily close relationship between

debt management and monetary operations.

B. The Nature and Problems of Debt Management

4. The importance of debt management as an instrument of public financial policy in Canada arises essentially from the magnitude of Government debt outstanding in the form of direct and guaranteed securities. The total amount of such debt at the end of April 1962 was $18,550 million, about one-fourth of the total of Canadian public and private debt outstanding. Government securities clearly constitute an important factor in the structure of the financial assets held by lenders and investors and in the liquidity of the economy.

5. Broadly speaking, this debt represents the cumulative total of all Government cash deficits less surpluses since Confederation, the deficits having been financed through the sale of new securities and the surpluses having been used to reduce the total of securities outstanding. After allowing for changes in cash balances, changes in debt in any period represent the net balance between Government cash receipts and outlays of all kinds and are thus the consequence of Government actions with respect to its outlays and receipts -- that is, broadly speaking, of its fiscal operations. The Government's fiscal operations -- and particularly the levels and character of the taxation and expenditure involved -- have very important direct effects on the performance of the economy, and on particular industries, regions or economic groups, but these lie beyond the scope of this submission.

6. Debt management is concerned with the

A. The Nature and [illegible]

4. The importance of debt management as an instrument of public financial policy in Canada derives essentially from the magnitude of Government debt outstanding in the form of direct and guaranteed securities. The total amount of such debt at the end of April 1962 was $20,250 million, about [illegible] the total of Canadian public and private debt outstanding. Government securities clearly constitute an important portion [illegible] of the financial [illegible] and investors and [illegible]

5. Broadly speaking, this debt represents the cumulative total of all Government cash deficits less surpluses since Confederation, the deficits having been financed through the sale of new securities and surpluses having been used to reduce the total of securities outstanding. After allowing for changes in cash balances, changes in total debt outstanding [illegible] the net balance between Government cash receipts and outlays of all kinds and the net [illegible] Government actions with respect to the [illegible] — that is, broadly speaking, of its [illegible]. The Government's financial [illegible] the levels and [illegible] and expenditure involved — have very important effects upon the performance of the economy, [illegible]

6. Debt management is concerned with [illegible]

characteristics of the securities which constitute the Government debt and with the terms and conditions under which they are issued and redeemed. Decisions in such matters necessarily have an influence on the attractivness of these securities as compared with other types of financial assets available to investors, and on the prices, yields and other terms and conditions under which money is borrowed and repaid and financial assets are held and traded, i.e. on credit conditions generally. In this respect debt management is similar to monetary management; both can exert an influence on the performance of the economy indirectly through their effects on credit conditions. Since credit conditions are bound to be substantially affected by the actions taken in each of the fields of fiscal policy, debt management policy and monetary policy there is clearly need for close and continuing co-ordination of these various aspects of public financial management.

7. Some of the main differences in the characteristics of the Government's direct and guaranteed securities outstanding are shown in the following table.

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[illegible] Some of the main differences in the economic features of the Government's direct and guaranteed securities outstanding are shown in the following table.

Composition of the Direct and Guaranteed Securities of the Government of Canada as at April 30, 1962, (millions of dollars)

Market fixed-term securities	
Treasury bills	1,885
Bonds - under 2 years to maturity	3,027
- over 2 years to 5 years to maturity	2,893
- over 5 years to 10 years to maturity	955
- over 10 years to 15 years to maturity	2,004
- over 15 years to maturity	3,451
Market perpetual bonds	55
Market issues matured and outstanding	26
Non-market securities Canada Savings Bonds	4,042
Bonds issued to the Unemployment Insurance Fund	34
	18,552
Of which payable solely or optionally in foreign currency	122

8. The outstanding securities differ widely in their term to maturity, ranging from treasury bills, some of which fall due for repayment each week, to a bond issue due on March 15, 1998. There are also bonds for which no final maturity date is specified and which are therefore known as perpetuals. The contractual rate of return on Government securities also differs widely. Treasury bills do not provide the holder with any specified rate of interest but ate sold at a discount which is the effective yield. Market issues of bonds now outstanding carry a specified rate of interest which ranges between 2 3/4 per cent and 5 3/4

per cent. Offerings of market issues are often made at a discount, and in the case of short-term issues this discount is sometimes an appreciable element in the over-all rate of return to the buyer. Certain issues of short-term bonds offer the holder the option of exchange into long-term bonds at any time prior to a specified date. Market issues of securities are freely transferable between holders, while Canada Savings Bonds and the special issues held by the Unemployment Insurance Fund are not. In recent issues of Canada Savings Bonds the coupon rates of interest vary, rising with the length of time the bond is held. Canada Savings Bonds may be held only by individuals and estates, and an individual's holdings of any one issue may not exceed a stipulated maximum amount except by inheritance. Canada Savings Bonds are redeemable at par on demand by the holder, differing in this respect from market issues. The Government has issued bonds denominated in foreign currency (the last occasion being in 1950) or redeemable in one or more foreign currencies or Canadian dollars at the option of the holder (the last occasion being a guaranteed issue sold in 1931). Some bonds have been issued subject to redemption at the call of the Government prior to maturity. Since 1959, issues of Government-guaranteed bonds have provided for a purchase fund operating according to certain specified rules. Since June 1961 a general Purchase Fund has operated in connection with outstanding direct long-term issues. Purchasers of market issues of Government securities are offered a wide range and interchangeability of

[illegible] cent. Offerings of market issues are often [illegible] a discount, and in the case of short-term issues the discount is sometimes an appreciable element in the over-all rate of return to the buyer. Certain issues of short-term bonds offer the holder the option of exchange into longer-term bonds at any time prior to a specified date. Market issues of securities are freely transferable between holders, while Canada Savings Bonds and the special issues held by the [illegible] are not. In recent issues of Canada Savings Bonds the coupon rates of interest vary, rising with the length of time the bond is held. Canada Savings Bonds may be held only by individuals and estates, and an individual's holdings of any one issue may not exceed a stipulated maximum amount except by inheritance. Canada Savings Bonds are redeemable at par on demand by the holder, differing in this respect from other issues. The Government has issued bonds payable in foreign currency (the most recent being in [illegible]) or redeemable in one or more foreign currencies or in dollars at the option of the holder (the last such being a renovated issue sold in [illegible]). Some bonds have been issued subject to redemption at the option of Government prior to maturity. Since 1959, [illegible] [illegible]-term issues have provided for a [illegible] fund operating according to certain specified rules. Since June 1961 a general Purchase Fund has operated [illegible] [illegible] with outstanding direct [illegible]-term issues. [illegible] of recent issues of [illegible] [illegible] a wide range and [illegible].

denominations and a choice between holding the security in registered or in bearer form.

9. The wide diversity in the characteristics of various issues of Government securities referred to in the preceding paragraph reflects one of the basic aims of debt management -- to tap as wide a range as possible of potential markets. There are great differences in the kinds of instrument which best suit the requirements of different classes of investor, and an important function of debt management is to make available to investors securities which embody the particular characteristics they want. An interesting and important example of this diversification of Government securities in order to meet the potential demand is Canada Savings Bonds. The savings plans of many individuals involve a relatively long investment period but must at the same time provide for immediate access to the funds invested in the event of unforeseen contingencies. By selling bonds which are redeemable on demand the Government has been able to tap savings which it could not otherwise reach; the risk to the Government of large-scale redemption is limited by making the instrument eligible for purchase only by resident individuals and estates and not in excess of modest amounts. In the sixteen series of Canada Savings Bonds since their inception in 1946 sales have averaged 1,150,000 in number. The total number of investors acquiring marketable Government bonds in any year cannot be established but the average number participating in the original distribution of new issues at time of

[illegible] 1-4 a [illegible] between [illegible]

[illegible]

6. The wide diversity in the [illegible] of various issues of Government securities referred to in the preceding paragraph reflects one of the basic aims of debt management -- to tap as wide a range as possible of potential markets. There are, of course, differences in the kinds of investment which best suit the requirements of different classes of investors, and an important function of debt management is to make available to investors securities which embody the particular characteristics they want. [illegible] and [illegible] of [illegible] Government securities in order to meet the [illegible] demand [illegible] Savings Bonds. The savings [illegible] of many individuals [illegible] [illegible] not [illegible] the [illegible] the funds [illegible] in the [illegible] [illegible]. By [illegible] Government [illegible] has been able to tap [illegible] [illegible] of [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] Government bonds [illegible] [illegible] average [illegible] the [illegible] [illegible]

offering since 1950 has been 5,400, and the largest number of sales achieved in one issue was 30,400.

10. One of the main areas of decision in debt management is the term of securities to be issued, and decisions with regard to this matter have an influence on the structure of interest rates. If, for example, new issues were concentrated in either the short or the long end of the market to an extent which brought about a marked shift in the maturity distribution of Government securities outstanding, the result would tend to be a higher level of interest rates in the maturity area in which the new issues were concentrated, and lower rates elsewhere, than would otherwise have prevailed. Debt management operations may thus have a considerable influence on the shape of the interest-rate curve, that is, on the relative yields of securities of different terms to maturity. The range of choice is of course limited to the alternative ways of selling a given amount of new Government securities of some kind, since the Government must get the money it requires and the total amount of securities involved have to be placed in one way or another. When the Government is running an over-all cash deficit holders must be found for a rising volume of Government securities, but even when the Government has a cash surplus and its security debt is declining, some of its outstanding securities will mature from time to time and will probably need to be refunded at least in part.

11. Insofar as debt management decisions influence the shape of the interest-rate curve they may

[illegible] (7) and one [illegible], and the largest proportion of [illegible] in the [illegible] was 30,000.

33. One of the main sources of distortion in [illegible] is the term of security to [illegible]. [illegible] which [illegible] to this matter have an influence on the structure of interest rates. If, for [illegible] [illegible] were [illegible] to [illegible] the [illegible] of the market to an extent which [illegible] [illegible] [illegible] the [illegible] of [illegible] [illegible] [illegible], the result would tend to be a higher level of interest rates [illegible] ability [illegible] [illegible] [illegible] more [illegible], and [illegible] [illegible] [illegible], [illegible] [illegible] have [illegible]. [illegible] [illegible] [illegible] may have [illegible] a [illegible] [illegible] [illegible] [illegible] of the [illegible] [illegible] [illegible] [illegible] the [illegible] [illegible] of [illegible] of [illegible] [illegible] to [illegible]. The [illegible] of [illegible] [illegible] [illegible] to the [illegible] [illegible] of [illegible] a [illegible] [illegible] of [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] of [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]. [illegible] the [illegible], [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible], [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] at least in part.

34. [illegible] [illegible] [illegible] [illegible]

[illegible]

tend to change the impact of credit conditions on various sectors of the community. To the extent, for example, that businesses, or provincial and municipal governments, or house builders are more dependent on long-term borrowing than on short-term borrowing an upward (or downward) shift of long-term interest rates relative to short-term ones will be especially unfavourable (or favourable) to these sectors.

12. Decisions regarding the term to maturity of Government securities to be issued will be influenced by the type of distribution which it is desired to achieve. Some investors such as life insurance companies and pension funds normally tend to prefer longer-term issues and other investors such as the chartered banks, the "near-banks" and non-financial corporations usually prefer shorter-term securities. Investor preferences may on occasion depart substantially from normal as a result, for example, of shifts in expectations regarding the future course of interest rates, but they must always be kept in mind in deciding the term to maturity of new offerings of securities. To be absorbed smoothly with a minimum of disturbance the securities offered must incorporate the term to maturity, yield and other characteristics wanted by investors. Otherwise the result is likely to be market indigestion, falling bond prices, and unsettling effects on market expectations. In the interests of having a saleable product the preferences of the market must be given as much weight as other considerations of public financial policy permit.

used to gauge the impact of current conditions on various sectors of the community. At one extreme, for example, [illegible] overtightness, or protracted and manifold government [illegible] or [illegible] these sectors are more dependent on long-term borrowing than on short-term, an upward (or downward) shift of long-term interest rates relative to short-term ones will be especially unfavorable (or favorable) to these sectors.

17. Decisions regarding the [illegible] of investment [illegible] to be based [illegible] by the type of institution [illegible] it is designed to [illegible]. [illegible] such as life insurance companies and pension funds normally tend to prefer long-term [illegible] and other investors such as [illegible] the "near-money" [illegible]

[illegible]

[illegible] for example, [illegible] expectations regarding the future course of interest rates, but they must always be ready to [illegible] to the [illegible] to [illegible] substantial [illegible]. [illegible] considerations affecting [illegible] liquidity, yield and other [illegible] [illegible] institution, [illegible] and [illegible] of different securities. [illegible] as [illegible] [illegible]

13. In managing the maturity structure of its outstanding securities the Government will obviously wish to give maximum support to the objectives of financial policy at minimum interest cost to itself. Although the interest yield on short-term securities is normally lower than that on long-term securities, the cost of the debt to the Government would not necessarily be minimized by issuing only short-term securities. Such a policy would greatly increase the frequency of refunding operations and the expenses associated with them; moreover, the average interest cost of the debt might in fact be higher as a result of over-loading the market with short-term instruments and failing to take advantage of the demand for longer-term issues. Even when some shortening of the average maturity of the outstanding debt could reduce the interest costs to the Government, it would be undesirable if it were inconsistent with the broader aims of Government financial policy in the prevailing economic circumstances.

14. In this connection there are a number of general considerations which are relevant. The first is that the average term to maturity of the outstanding debt is subject to an automatic process of shortening simply through the passage of time. Another is that a reduction in the term of the Government debt outstanding increases the liquidity of the economy, since short-term securities are closer substitutes for money than securities of longer term. There will of course be occasions on which an increase in liquidity is appropriate. Situations may also emerge, however, in which the

13. In managing the maturity structure of its outstanding securities the Government will certainly wish to give maximum support to the objectives of financial policy at minimum interest cost to itself. Although the interest yield on short-term securities is normally lower than that on long-term securities, the cost of the debt to the Government would not necessarily be minimized by issuing only short-term securities. Such a policy would greatly increase the frequency of refunding operations and the expenses involved with them; moreover, the average interest cost of the debt might in fact be higher as a result of continually going to market with short-term instruments and failing to take advantage of the demand for longer-term issues. Even when some shortening of the average maturity of the outstanding debt could reduce the interest cost to the Government, it would be undesirable if it were inconsistent with the broader goals of Government financial policy in the current economic situation.

14. In this connection, there are two other general considerations which are relevant. One is that the average term to maturity of the debt is subject to automatic shrinkage in the absence of [illegible] simply through the passage of time. Moreover, a [illegible] in the term of the Government debt [illegible] the liquidity of the economy, since short-term securities are closer substitutes for money [illegible] than are longer term. [illegible] [illegible] in which [illegible] [illegible] very close [illegible]

previously generated liquidity will be found to be excessive and unless fiscal policy reacts promptly to produce a surplus of receipts over outlays it may prove very difficult, and perhaps impossible, to mop up the excess liquidity enough to keep the trend of total spending in the economy within desirable limits. Too rapid a growth in the liquidity of the economy could also inspire apprehension about inflation and generate selling pressure in the bond market with effects on the credit situation opposite to those desired. Problems of this sort would be aggravated by another consequence of a large short-term Government debt, namely, that sizeable refunding operations have to be carried out frequently, and this tends to restrict the room for flexibility in monetary management. Large refundings are difficult to carry out smoothly in periods in which security prices are unsettled, but on the other hand there must be some preiods during which price adjustments can occur if credit conditions are to vary as required by changing economic circumstances.

15. One technique of debt management to which reference should be made is the use of Government investment accounts to buy, hold, and sell securities for debt management purposes. (See paragraphs 57 and 58 below.) Since, after allowing for the temporary use of cash balances, the purchases of such accounts will ordinarily require an increase in the amount of securities issued in some other area of the market, the usual effect of such operations over a period of time is to cause changes in the structure of the Government

previously generated [illegible] be found in the
successive [illegible]
produces a surplus of [illegible]
more difficult, and perhaps impossible, to [illegible]
[illegible] enough to [illegible]
[illegible] in the economy [illegible].
The rapid growth in the [illegible] of the [illegible]
[illegible]
[illegible]
[illegible]
Problems of this sort would be aggravated by [illegible]
accumulation of [illegible]
Finally, that [illegible]
[illegible]
[illegible]
[illegible] are difficult to [illegible]
[illegible]
[illegible]
[illegible]
[illegible]
C. [illegible]
[illegible] should be made [illegible]
[illegible]
[illegible] (See [illegible])
[illegible]
[illegible]
[illegible]
[illegible]
[illegible]

debt and in its distrubition among various types of holders rather than in its size. These will have an effect on the liquidity of the economy and on credit conditions generally.

16. In recent years the Government has engaged in a process of "advance refunding" of some of its nearby maturities held by the Bank of Canada which has been helpful in avoiding market disturbances which might have been caused by refunding issues which were unusually large or which had to be carried out under difficult market conditions. The Bank of Canada has purchased the nearby maturities in the market on the basis of switches for, or sales of, somewhat longer maturities up to the mid-term area. New mid-term securities obtained from the Government in exchange for the Bank's holdings of the nearby maturities have provided a diversification in the Bank's portfolio which has enabled it to continue the process of obtaining nearby maturities from the market. In the case of the 3 per cent Government of Canada issue which matured on December 1, 1961 the original outstanding amount of $1,021 million had been reduced by advance refundings to $445 million before the maturity date. The process described has affected the maturity distribution of Government securities held by the private sector by enabling the Bank to place with investors moderate amounts of mid-term issues and to achieve, without disturbance to the market, some modest offset to the shortening of the debt which was taking place.

17. With debt management policy and monetary

policy conducted on the basis of common views regarding the kind of credit conditions which are appropriate to the economic circumstances there is much that each can do to complement the other. The choice of maturities and offering prices and the general handling of new securities issues as well as the operation of debt management accounts can support the efforts of the central bank to exercise an appropriate influence on credit conditions. Similarly, cash reserve management and the open market operations of the central bank can help to moderate short-term fluctuations in the level and structure of yields and to assist the smooth and orderly marketing of new issues.

[illegible] on the basis of common views in [illegible]
[illegible] of current [illegible]
[illegible] circumstances there is much that each [illegible]
complement the other. The choice of maturities and
offering prices and the general handling of new
[illegible] issues as well as the operation of [illegible]
[illegible] accounts can [illegible] the [illegible] of [illegible]
[illegible] of [illegible]
[illegible] conditions. Similarly, when new [illegible]
and the open market operations [illegible]
[illegible] to [illegible]
[illegible] and structure of [illegible]
[illegible] not only [illegible].

C. The Bank of Canada as Fiscal Agent in Debt Management

General

18. The underlying Parliamentary authorization for the Government's borrowing operations is provided in the Financial Administration Act and in yearly Appropriation Acts. The precise terms of each borrowing operation are approved by order-in-council before any public offering is made. From time to time directives are issed to the Bank on specified phases of forthcoming borrowing operations. In connection with Canada Savings Bonds, for example, the Government instructs the Bank regarding the programmes of advertising and promotion and limits on the costs of flotation.

19. To help in considering the timing and size of future borrowing operations the Bank of Canada prepares monthly, and revises weekly, a detailed projection of the Government's sources and uses of cash and its month-end cash balances. Comparisons are made with projections prepared independently in the Department of Finance. When balances are low, projections of daily balances over short periods are made. There are obvious difficulties, however, in predicting the precise timing of the cash effect of known programmes, and more formidable problems relating to Exchange Fund and Purchase Fund operations, the rate of sale and/or redemption of savings bonds, and variations in the "float" of unpaid cheques outstanding.

20. In order to keep abreast of changes in investor preferences and in the demand for funds, the

[illegible] of [illegible] Agent [illegible]

[illegible]

19. The [illegible]

for the Government's [illegible] to prove [illegible]

[illegible] Appropriations Act [illegible]

appropriation acts. The proof [illegible]

[illegible] informa[illegible]

[illegible] to make. From time to time [illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

20. [illegible]

[illegible]

central bank records and analyses the evidence available on the shifting distrubition of outstanding debt (with particular emphasis on nearby maturities), securities prices and yields, and the flows of funds in the capital market as reflected in both new issues activity and secondary dealing.

21. There are frequent informal discussions with officials of the Department of Finance with regard to the economic and credit situation and the range of alternatives open to the Government in planning its debt management programme for some time ahead, as well as more specifically with regard to the timing, size and characteristics of the next offering. When new issues are being considered officials of the Bank and the Department of Finance have similar discussions with the Minister of Finance at which consideration is also given to views or suggestions which have been put forward private from time to time to the Bank of Canada or the Department of Finance by investment dealers, bankers, or investors. In due course the Bank is informed of the Government's decision.

Arrangements in Connection with New Issues

22. New offerings of market issues are made by the Bank of Canada on behalf of the Minister of Finance to investors through a network of intermediaries known as primary distributors. Only primary distributors may subscribe directly for market issues including treasury bills. At the present time the group of primary distributors includes the eight chartered banks, the two Quebec savings banks and about 270 investment

dealers. New applicants are carefully investigated; they must have a proven record of active and continuous distribution of high-grade securities and be financially responsible. Head offices of the firms now in the group are located in all ten provinces and maximum geographical diversification is aimed at. There have been no instances of misappropriated funds or failure to deliver securities reported to the Bank of Canada by investors in connection with any new offering of Government of Canada securities in the post-war period.

23. In connection with Canada Savings Bonds, the distributing group is enlarged to include trust and loan companies, caisses populaires, provincial savings offices and additional investment dealers. In both market and non-market financing, investment dealers are usually authorized to appoint sub-agents for whose actions the primary distributor is held fully responsible.

24. Each new issue involves the Bank of Canada in a considerable amount of administrative work. Early in the preparations a time-table is proposed to facilitate an appropriate selection of dates for the various announcements connected with the issue, the time and day of offering and of closing the subscription book, the delivery date, etc. Bonds are ordered from the two bank note companies and instructions given regarding the text to appear on the bonds and coupons. Preparations are made to mail material related to the offering and letters confirming the allotments.

25. In recent issues a brief announcement has been made by the Minister of Finance in which the

residents. The conclusions from research [illegible]

[illegible] general level of [illegible]

distribution of high-grade securities [illegible]

communities, and [illegible]

the increase in [illegible] the provinces [illegible]

[illegible]. These data [illegible]

[illegible]

[illegible]

in connection [illegible]

[illegible]

43. In [illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

type and amount of borrowing are indicated two or three days before the detailed terms of the offering are disclosed. The text of this statement is sent by telegram to eligible primary distributors.

26. The official offering telegram to primary distributors is necessarily a lengthy document, and the telegraph companies are notified a few hours ahead, under appropriate conditions of secrecy. Telegrams are scheduled wherever possible for simultaneous release across the country and the telegraph companies need to have enough messengers available to complete all deliveries within fifteen minutes. The telegraph companies are not permitted to transmit the contents of wires to the addresses by telephone.

27. In most recent bond issues about 60 per cent of the amount available for market absorption has been offered to primary distributors on a firm basis, and subscriptions have been invited for the remaining 40 per cent. Subscriptions by any individual distributor have been limited to an amount of funds that is not greater than two times the amount of bonds that have been accepted on a firm basis. After the subscription books have been closed the bonds offered on a subscription basis and any offered on a firm basis and not accepted have been alloted pro rata to the primary distributors who have entered subscriptions.

28. The descriptive material released for each new issue includes a prospectus describing the issue, an advertisement in daily newspapers across Canada, and various news releases that are sent out prior

to, at the time of, and after the completion of the offering. In addition, a memorandum of procedure and a large number of forms to facilitiate administration are sent by mail to primary distributors at the time offering. The Bank receives and tabulates acceptances of firm bonds and of subscriptions, calculates and notifies the allotments, receives the delivery instructions and makes preparations for delivery of the bonds across the country.

29. The primary distributor sends the Bank of Canada a report of the distribution of the bonds allotted to him and any purchased in the after-market, usually about five weeks after the date of offering. This information is recorded and analysed to gain as much insight as possible into the nature of the distribution of the issue, investor interest, and the relative placing power of individual primary distributors.

30. The amount of bonds offered on a firm basis to a primary distributor is based on his ability to distribute such bonds to investors, as determined by his record of taking up firm offerings in past issues and the character of the distribution achieved. The allotment of firm bonds is one of the most difficult tasks which the Bank has in the debt management field; great efforts are made to assemble and analyse all relevant information regarding distributive capacity and to allot firm bonds on an objective basis.

Problems of "Over-Trading" and "Riding"

31. One of the conditions to which primary distributors agree when subscribing for a new loan is the

[illegible] at the time of, and after the [illegible] offering. In addition, a [illegible] of personnel and a large number of [illegible] in order to facilitate their administrative [illegible] work [illegible] ordinary [illegible] of the [illegible] offering. The bank receives and transfers [illegible] of firm bonds and of subscriptions [illegible] verifies the allotments, receives the delivery [illegible] and makes preparations for distribution [illegible] [illegible].

29. The primary function [illegible] of funds [illegible] and [illegible] allotted to [illegible] and only incidental [illegible] in the [illegible] usually about [illegible] the [illegible] of [illegible]. This [illegible] [illegible] as far as possible [illegible] distribution of the [illegible] [illegible] relation [illegible] of [illegible].

30. [illegible]

[illegible]

[illegible]

[illegible]

31. [illegible]

[illegible]

price at which they will distribute the issue. To assist in orderly marketing, primary distributors may not sell new bonds to investors below the issue price until they have been advised that this price restriction no longer applies. In recent issues, this price restriction has been removed at the close of business on the day before delivery of the new bonds, so that it remained in force for about two weeks from the offering date. The price restriction may, however, be removed whenever conditions in the market indicate that it is no longer appropriate, and this may precede or follow the delivery date by one to two weeks. When a new issue has been well placed and its price is firm at, or a little higher than, the issue price (and when prices on Government bonds generally, but particularly in the maturity area of the new issue, are firm) the removal of price restrictions would be warranted. On the other hand, when the price of a new issue is weak after the offering date it may be appropriate to retain the price restriction in order to prevent an early fall in the issue's price from hampering its successful placement; potential buyers may withhold purchases if they expect to be able soon to buy the bonds more cheaply. It should be noted that the price restriction applies only to offerings and sales to investors; it does not apply to transactions between primary distributors.

32. The price restriction is, of course, only effective to the extent that it is observed. When the response to a new offering is uncertain or slow, primary distributors may become worried about their prospects

[illegible] at which they will [illegible] issue. [illegible]
an orderly [illegible]
[illegible] to [illegible]
have been advised that [illegible] price [illegible]
applies. [illegible] recent [illegible], [illegible] prices [illegible]
been required [illegible] of business on [illegible]
[illegible] of the new [illegible]
[illegible] about two weeks from [illegible]
[illegible], however, [illegible]
[illegible] the [illegible]
[illegible] this may [illegible]
[illegible] two weeks. [illegible]
[illegible] price [illegible]
[illegible] prices [illegible]
[illegible] particularly in [illegible]
[illegible] the [illegible] of price [illegible]
[illegible]. On the other [illegible]
[illegible] 10 week [illegible]
[illegible] to [illegible] the price [illegible]
[illegible]
[illegible]
[illegible]
[illegible]. [illegible]
[illegible]
[illegible]

[illegible]

30. The [illegible]
[illegible]
[illegible] of a [illegible]
[illegible] may [illegible]

of placing the new bonds and may fear being caught with an inventory of slow-moving bonds in a falling market. If there is a strong incentive to circumvent the price restriction "over-trades" may develop. An over-trade occurs when a new issue is sold to an investor at the issue price in exchange for another issue for which the primary distributors pays more than the market price. Although the price restriction on the new issue is technically observed, the loss which the primary distributor absorbs on the issue purchased from the investor results in undercutting the price restriction. The primary distributor's commission is in effect reduced or eliminated. When over-trades begin, they tend to spread to more and more transactions and to grow in size under the pressure exerted by investors, particularly large investors. Over-trading often cintributes to disorderly markets and hampers distribution to investors.

33. The effective placement of a new issue with investors may also be hampered if its price advances too strongly under the impact of speculative purchases. Some speculative activity is always present in the capital market and in moderation it can play a constructive role, but when it becomes excessive it can produce price distortions which impede the optimum flow of investible funds. For example, a "rider" may place an order for a new issue, the price of which is rising, and sell it before delivery date; he would be taking a profit on the price increase without having to put up any capital, since he would not be required to pay

...ong the new [illegible]

[illegible]

If there is a strong incentive [illegible]

[illegible] ("...-standardized") may develop. [illegible]

occurs when a new issue is [illegible]

[illegible] price [illegible]

[illegible] distribution [illegible] more [illegible]

although the [illegible]

[illegible] observed, [illegible]

[illegible] on the [illegible]

[illegible]

the [illegible]

[illegible] or [illegible]

[illegible] to spread [illegible] and more [illegible] and

[illegible] the pressure exerted by [illegible]

[illegible]

[illegible] to [illegible]

[illegible]

15. The [illegible]

[illegible]

[illegible]

[illegible]

[illegible] the capital [illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible] a [illegible]

[illegible]

for the bonds until delivery date. The inflated, but short-lived, demand created by the riders may cause an unrealistic temporary price increase, followed by a rapid price drop when some riders unload their bonds in an attempt to realize their profits. Once the price begins to weaken, the effect may be accelerated by the anxiety of other riders to sell their bonds before all their potential profit disappears or their losses become too great.

34. Orderly marketing of an offering of new bonds is important not only for the particular issue concerned but also for the reception which will be accorded future issues. Primary distributors and investors who have been involved in unfortunate developments with one issue are apt to demand greater price concessions on, and may take a more speculative view of, the next issue.

35. The Bank of Canada keeps in continuous close contact with the reception of a new issue. The price quotations on bonds may indicate whether excessive speculation or over-trading is developing, and information from primary distributors helps in interpreting price movements, in identifying the sources of demand, and in estimating the size of the inventories still to be distributed.

Treasury Bill Auction Procedure

36. Since 1953 auctions of Government of Canada treasury bills have been conducted once a week, normally on Thursday, by representatives of the Department of Finance, assisted by members of the staff of the Bank of

for the bonds until delivery date. The inflated, but short-lived, demand created by the riders may cause an unrealistic temporary price increase, followed by a rapid price drop when some riders unload their bonds in an attempt to realize their profits. Once the price begins to weaken, the effect may be accelerated by the anxiety of other riders to sell their bonds before all their potential profit disappears or their losses become too great.

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Treasury Bill Auction Procedure

56. Since 1953 auctions of Government of Canada treasury bills have been conducted once a week, normally on Thursday, by representatives of the Department of Finance, assisted by members of the staff of the Bank of

Canada. Before each auction a notice of call for tenders is distributed by the Bank of Canada, acting on behalf of the Minister of Finance, to a list of banks, investment dealers, institutions and other business organizations. The notice states the amounts and terms to maturity of the treasury bills to be auctioned, and the conditions under which the auction will be conducted. Recently the weekly issue has consisted of $95 million of 13-week bills and $25 million of 26-week bills.

37. Sealed tenders may be submitted by banks and investment dealers included in the list of primary distributors and by the Bank of Canada, either by telegram or on special forms provided for the purpose. Corporations, non-bank financial institutions, individuals, and other purchasers must obtain their requirements through the banks and dealers who participate in the tender. The sealed tenders are held by the Audit Department of the Bank of Canada for delivery to representatives of the Department of Finance, who open them at 12:00 noon on the day of the tender.

38. The highest bidder is allotted the quantity of bills bid for at his price. Succeeding high bids also are allotted bills in full, and bids at the lowest successful price are allotted pro rata.

39. The average prices and the average yields are computed for each maturity and the information is made public at about 2:00 p.m. in a press release, which also gives the high and low accepted prices and equivalent yields, the date of the next auction and the amounts and

[illegible] is distributed by the Bank of Canada, [illegible] of the Minister of Finance, [illegible] investment dealers, [illegible], and other business organizations. The notice [illegible] and [illegible] of the [illegible] bills [illegible], and the conditions under which the [illegible] will be [illegible]. [illegible] the [illegible] [illegible] of [illegible] million of [illegible] bills and [illegible] million of [illegible] bills.

37. Sealed tenders may be [illegible] by banks and investment dealers [illegible] the [illegible] of [illegible] [illegible] and by the Bank of Canada, [illegible] forms provided for this purpose. [illegible]

[illegible]

[illegible] must obtain their [illegible] [illegible] and dealers who participate in [illegible]. The [illegible] tenders are held by the [illegible] of the Bank of Canada for delivery [illegible] of the [illegible] of Finance, [illegible]

[illegible]

[illegible]. The highest [illegible] [illegible] [illegible]. [illegible] [illegible] [illegible] [illegible] prices are [illegible].

[illegible]. The average price and the average [illegible] computed [illegible] and the information [illegible] at about [illegible] p.m. [illegible] the high and low [illegible].

[illegible] the date of the [illegible]

terms to maturity of the bills to be offered at that time.

40. Treasury bills won at tender are delivered on the following business day at any agency of the Bank of Canada in denominations of $1,000, $5,000, $25,000, $100,000 or $1,000,000. On auction day the successful bidders are notified by telephone of the par value won by them and the amount payable; they have until 4:00 p.m. to inform the Bank of Canada regarding the denominations required and the agency or agencies at which delivery will be taken. Delivery must be taken by 3:00 p.m. on the day after the tender against payment by certified cheque, bank draft or clearing house settlement.

Canada Savings Bonds

41. In acting as fiscal agent of the Government for the sale of Canada Savings Bonds, the Bank of Canada is concerned with a variety of operations. Planning for an issue each Fall usually begins in February with discussions of sales targets for the campaign and analysis of the general economic and financial environment. Working closely with representatives of advertising agencies appointed by the Minister of Finance, the Bank helps in the development of an advertising budget and general copy theme. Ministerial approval is obtained for this theme and for the distribution of budgetted expenditures among the various advertising media, and the Bank continues to meet with and advise the agencies as art work and copy are prepared for use in the campaign. Printing of the many administrative forms and pieces of advertising which are required for the campaign are arranged through the Queen's Printer. Close liaison is

terms to maturity of the bills to be offered at each tender.

40. Treasury bills won at tender are delivered on the following business day at any agency of the Bank of Canada in denominations of $1,000, $5,000, $25,000, $100,000 or $1,000,000. On auction day the successful bidders are notified by telephone of the par value won by them and the amount payable [illegible] to inform the Bank of Canada regarding the denominations required and the agency at which delivery will be taken. Delivery must be taken by 3:00 p.m. on the day either [illegible] against payment by certified cheque, bank draft or clearing house settlement.

[illegible]

41. In acting as fiscal agent of the Government for the sale of Canada Savings Bonds, the Bank of Canada is concerned with a variety of operations. Planning for an issue each Fall usually begins in March with discussions of terms, lengths [illegible] and analysis of the general economic and financial environment. Working closely with representatives of [illegible] securities appointed by the Minister of Finance, the Bank [illegible] in the development of an advertising budget and general copy themes. Ministerial approval is obtained for this theme and for the distribution of budgeted expenditures among the various advertising media, and the Bank continues to work with the [illegible] as art work and copy are prepared for use in the campaign. Printing of the bonds, application forms and [illegible] advertising which are required for the campaign [illegible] arranged through the Queen's Printer. [illegible]

maintained to ensure that deliveries of printed material are made at the times and in the locations required. In a number of instances secondary distribution of the material is made through the Bank's regional offices. The Bank provides supervision over all budgetary expenditures through a budget control system. Ultimate authority for payment rests, of course, with the Treasury Board.

42. For each series of Canada Savings Bonds, arrangements are made with the chartered banks and other selected financial institutions to provide the facilities required for the issuance, sale, financing and redemption of the bonds. The Bank normally formalizes these arrangements in late summer. Concurrent arrangements are also made with some 300 investment dealers and other representatives of the financial community authorizing them to act as sales agents and to appoint sub-agents as required, subject to prescribed conditions. Written agreements are obtained from issuing and sales agents, in which they undertake to adhere to procedures outlined in various memoranda of information and instructions.

43. In each Canada Savings Bond campaign considerable emphasis has been placed on the sale of bonds through payroll deduction. These sales normally provide about one-fifth or gross sales in dollars and about one-half in number. To assist employers who are willing to provide their employees with payroll purchase facilities, the Bank of Canada is authorized by the Minister of Finance to create a Payroll Savings

are made at the bases and in the locations required. In a number of instances temporary [illegible] material is made through the Bank's regional office [illegible] [illegible] provides supervisory over all building operations [illegible] [illegible] a budget control section, and [illegible] [illegible] for payment, [illegible] [illegible] [illegible]

62. For each series of Bank's [illegible] [illegible], arrangements are made with [illegible] [illegible] [illegible] selected financial institutions to provide [illegible] [illegible] required for the [illegible], [illegible] [illegible] of the [illegible]. The Bank [illegible] [illegible] arrangements in [illegible] [illegible]. [illegible] [illegible] [illegible] [illegible] [illegible] representatives of the [illegible] [illegible] [illegible] [illegible] them to [illegible] [illegible] and [illegible] [illegible] as required, [illegible] [illegible] [illegible] written agreement [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible]

63. [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] willing to provide [illegible] [illegible] [illegible] [illegible], the Bank of [illegible] [illegible] [illegible] [illegible] of [illegible] [illegible] [illegible] [illegible]

Organization. This organization, comprising about 125 organizers grouped in 5 geographic regions, is reconstituted annually and staffed by personnel supplied for varying periods by investment dealers. Central direction is provided by the Bank of Canada. Preliminary planning commences in the Spring and, working with the Regional Directors, the Bank provides the necessary statistical services, supervises the appointment of personnel, maintains up-to-date lists of firms to be covered, arranges for delivery of material and provides temporary office space and staff as required. During the campaign period, which runs for about 6 to 8 weeks, close personal liaison in the field is maintained by officers of the Bank who remain in touch with all phases of the operation. The Bank maintains budgetary control over the organization and recommends to the Minister the basis of remuneration to be paid to the investment dealers supplying personnel.

44. During the general campaign period, regional offices of the Bank act as clearing houses for sales progress reports from individual issuing agents. The regional reports are analyzed by the Bank in Ottawa in a continuous appraisal of the effectiveness of promotional activity. The tabulation of these results forms the basis of campaign press releases. These and other publicity releases are channelled to the various news media through news liaison officers retained by the Bank for the campaign period. Under Bank supervision these officers also provide public relations support to the Pryroll Savings Organization and to sales

[illegible] were grouped in 5 geographic areas, as is [illegible] and staffed by personnel supplied for [illegible] ices by investment dealers. General direction [illegible] ided by the Bank of Canada. [illegible] [illegible] the Bank provides [illegible] [illegible], supervises the employment of personnel, maintains up-to-date lists of firms [illegible] arranges for delivery of material and provides [illegible] [illegible] and staff as required [illegible] [illegible] period, which runs for about 6 to 8 weeks. [illegible] personnel [illegible] on the field [illegible] of the Bank who remain in touch with phases of the [illegible]. The Bank maintains [illegible] and [illegible] to the [illegible] on the basis of [illegible] to be paid to the investment dealers [illegible] personnel.

[illegible] the [illegible] of the Bank [illegible] from [illegible] [illegible] reports [illegible] [illegible] of [illegible] [illegible] [illegible] [illegible] by the [illegible] [illegible] these [illegible]

agents in numerous ways adapted to prevailing local conditions.

45. Printing of the large quantity of bonds required for a Canada Savings Bond issue is arranged by the Bank. As bonds become available they are distributed to the various Bank of Canada regional offices and through them to issuing agents. Fully registered bonds, that is, bonds registered as to principal and interest, are requisitioned from the regional offices by the issuing agents and registration is completed by these offices. Coupon bonds, which are registered only as to principal, are issued directly by issuing agents. During the campaign Bank of Canada regional offices receive settlements daily from issuing agents covering sales made to that date and deposit these to the credit of the Government. The Bank of Canada maintains the record of registrations in Ottawa.

46. Registration cards are prepared by the issuing agents in the case of coupon bonds and by Bank of Canada regional offices in the case of fully registered bonds. From them the Bank is able to check against violations of eligibility provisions and of the limit on total holdings of the issue by any one investor . These records also facilitate analysis of early redemptions of each new issue and verification of the bona fides of such transactions if this seems warranted. Commission payments due to sales agents are compiled by the Bank at Ottawa and payments made as necessary. A few months following each campaign period the Bank through its Audit Department undertakes spot audits of the issuing

persons in Warsaw were [illegible] to [illegible], [illegible] [illegible]tion.

(b) [illegible] of the [illegible] [illegible] of [illegible] [illegible] in [illegible] Jewish [illegible] is [illegible] by the [illegible]. As some [illegible] [illegible] they [illegible] [illegible] to the [illegible] [illegible] of [illegible] [illegible] [illegible] [illegible] them to [illegible] [illegible]. [illegible] [illegible] [illegible] [illegible] the [illegible] [illegible] as [illegible] and [illegible] [illegible] [illegible] from the [illegible] [illegible] by the [illegible] [illegible] and [illegible] [illegible] [illegible] by [illegible]. The [illegible] of [illegible] [illegible] and [illegible] [illegible].

(c) [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] in the [illegible] of [illegible] [illegible] and [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] of [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] of the [illegible] the [illegible] [illegible] [illegible] [illegible] [illegible] [illegible] of the [illegible]

agent's transactions to ensure that proper issue procedures have been followed and that the interests of the Government as borrower have been protected.

47. The Bank issues cheques annually for interest on fully registered Canada Savings Bonds. Coupon interest is paid by issuing agents but redeemed coupons are cleared through the Bank's regional offices for accounting and auditing. Redemption fees on redeemed bonds are calculated by the Bank and settlements made periodically to issuing agents. The Bank also verifies the authenticity of redeemed bonds.

Delivery Arrangements for New Market Issues

48. Delivery of definitive bonds in either coupon or fully registered form is usually made within two to three weeks from the day that the bonds are first offered. Delivery of new bonds is normally made at the regional office of the Bank of Canada nearest the dealer's or bank's main office. However, a dealer or bank may take delivery at any regional office of the Bank by instructing the Bank on the delivery instruction form.

49. The Bank of Canada will also forward bonds by mail to primary distributors at any point in Canada except within the metropolitan area of any regional office. Where bonds are forwarded by mail by the nearest regional office of the Bank, arrangements for payment on the delivery date must be made with that office not later than two days prior to the delivery date.

50. Where fully registered bonds are desired, the Bank of Canada makes every effort to deliver them at

[illegible] transactions to ensure that proper pro-
cedures have been followed and that the interests of the Government as borrower have been protected.

39. The Bank [illegible] interest on fully registered United States Bonds. Coupon interest is paid by fiscal agents but canceled coupons are cleared through the Bank's regional offices for accounting and auditing. Remittances [illegible] on registered bonds are calculated by the Bank and [illegible] made periodically to fiscal agents. The Bank also verifies the authenticity of [illegible].

<u>Delivery Arrangements for New Bond Issues</u>

40. Delivery of definitive bonds [illegible] in connection with [illegible] from [illegible] the bonds are [illegible] offered. Delivery of new bonds is normally made at the regional office of the Bank at [illegible] or [illegible] Bank's main office. However, a [illegible] the delivery at any regional office of the Bank [illegible] on the [illegible]

[illegible]

41. [illegible] of [illegible] by mail to [illegible] of [illegible] the [illegible] within the [illegible] office. [illegible] regional office of the Bank, [illegible] the delivery date [illegible] be made [illegible] prior to the delivery date.

42. Where fully registered bonds are [illegible] the Bank [illegible]

the same time as coupon bonds, provided that registration instructions are made to the Bank not later than about one week prior to delivery. Payment is received when the bonds are delivered.

Transfers and Transmissions

51. The transfer of a bearer bond involves no records or signing procedures as this bond is deemed to be negotiable in the hands of the holder. When a bond is registered, however, an instrument of transfer must be prepared and signed by the registered owner or his personal representative. When the registered owner is a corporation, the instrument of transfer must be signed by the corporation's duly authorized officers and the corporation's seal must be affixed, where required.

52. The Bank of Canada is not required to give effect to an instrument of transfer unless the signature on the instrument is guaranteed by a chartered bank or a Quebec savings bank or a financial institution authorized to do so by the Bank. The Bank of Canada in authorizing a financial institution to guarantee signatures for this purpose may limit the amount of bonds that can be transferred in any one transaction.

53. When the registered owner of a bond has died, the Bank of Canada can, upon receipt of certain documents, give effect to the transmission of the ownership of the bond to a person specified in the documents. The required documents will usually include an authenticated or notarial copy of the probate of the will of the deceased owner, or of letters of administration of his estate granted by court. When the required

documents have been received by the Bank of Canada, the bonds to which they relate can be transferred upon completion of an instrument of transfer.

54. Since October 1953 the Bank of Canada has made it possible for any primary distributor to transfer treasury bills from one Bank of Canada regional office to any other for delivery the same day, without charge, provided the bills are lodged before 1:00 p.m. Eastern Standard Time. This means that a bill can be sold by an investment dealer in, say, Halifax, to a purchaser in, say, Vancouver, with a minimum of time required to make delivery.

55. In November 1954 these "wire transfer" arrangements were extended to Government of Canada bonds having a term to maturity not exceeding three years (i.e., money market securities) as well as Government of Canada bonds which had been called for redemption. A further extension of the arrangements was made in April 1960 to include all Government of Canada direct and guaranteed bonds provided that in the case of maturities exceeding three years the minimum amount to be transferred is $50,000 in any one issue. Registered bonds were also made acceptable for wire transfer, provided that the signatures and authority to sign were guaranteed by a chartered bank.

Securities, Transactions for Government Accounts and Crown Organizations

56. The Bank of Canada may execute securities transactions as agent for, and on instructions from, Crown corporations and agencies and for Government investment

[illegible] have been [illegible] as on [illegible] of Canada [illegible] to which they [illegible] be registered upon [illegible] of an instrument of transfer.

[illegible] Since October 1919 [illegible] made [illegible] possible for any primary distribution [illegible] money [illegible] from one [illegible] of Canada [illegible] [illegible] Scotia [illegible]. This [illegible] investment [illegible] [illegible] moreover, [illegible] of the [illegible] territory.

[illegible]

[illegible] were [illegible] Government of [illegible] a [illegible] [illegible] [illegible] [illegible] bonds which [illegible] [illegible] [illegible] [illegible] [illegible] Government of [illegible] [illegible] [illegible] three years [illegible] [illegible] [illegible] [illegible] also [illegible] [illegible] [illegible] [illegible] [illegible] by a [illegible]

[illegible]

[illegible]

[illegible]

accounts such as the Securities Investment Account and the Purchase Fund.

57. The Securities Investment Account was used fairly extensively during the war and immediate post-war years to purchase and sell Government of Canada bonds with a view to stabilizing their prices. It has also been employed to invest temporary excess cash balances of the Government of Canada although this has become less important with the introduction by the chartered banks of interest payments on Government of Canada cash balances over a certain minimum amount. From time to time it has purchased Government securities of nearby maturity for debt management purposes.

58. In the June 1961 budget the Minister of Finance announced the establishment of a Purchase Fund to provide for the orderly retirement of government debt and at the same time contribute to the stability of the longer term bond market. To March 31, 1962, cancellations of securities held by the Purchase Fund amounted to $166 million in par value.

59. In each securities transaction executed on behalf of Crown organizations or Government accounts the Bank of Canada states that the purchase or sale is for an account, and the subsequent contract shows that the Bank of Canada has acted as an agent rather than on its own behalf.

[illegible]

[illegible]

[illegible] The Exchange Fund [illegible] has been [illegible] fairly extensively during the war and [illegible] years to purchase and sell Government of Canada [illegible] with a view to stabilizing their prices. [illegible] designed to [illegible] [illegible] management of these [illegible] although this has [illegible] with the [illegible] of interest payments on Government of Canada [illegible] [illegible] It has purchased Government securities of [illegible] for debt management purposes.

[illegible] [illegible] [illegible] further occasion for establishment [illegible] to provide for the orderly retirement of [illegible] and at the same time [illegible]

[illegible]

[illegible] by the [illegible]

[illegible] in our [illegible].

[illegible] In each [illegible]

[illegible]

[illegible]

[illegible] on the [illegible].

Submission by the Bank of Canada to the
Royal Commission on Banking and Finance

May 31, 1962.

V. THE ROLE OF THE BANK OF CANADA IN FOREIGN EXCHANGE

May 31, 1962.

V. THE ROLE OF THE BANK OF CANADA IN FOREIGN EXCHANGE

A. Introduction

1. Since 1939 the direct responsiblity for Canada's foreign exchange policy has, under various Acts of Parliament, (The Foreign Exchange Control Order of 1939 under the War Measures Act, the Bretton Woods Agreement Act, 1945, the Foreign Exchange Control Act, 1946, and the Currency, Mint and Exchange Fund Act, 1952) been vested in the Government of Canada. The Bank of Canada Act gives the Bank power to buy and sell gold, silver and foreign exchange, to maintain deposits with other central banks and to act as agent and depository for central banks and international institutions, but the Bank's holdings of, and dealings in, gold and foreign exchange for its own account are small. However, the Bank carries out substantial foreign exchange transactions as fiscal agent for the Government and provides the Government with information and advice on foreign exchange matters. For these reasons it has seemed desirable to include a submission on foreign exchange in the Bank's evidence before the Commission. This submission discusses some general considerations relating to foreign exchange and describes the Bank of Canada's operations for the Government and its foreign clients. Appendix I describes briefly the International Monetary Fund, and Appendix II the foreign exchange market in Canada.

2. In the period between the opening of the Bank in 1935 and the imposition of foreign exchange

control on the outbreak of the war in 1939 the Bank carried some direct responsibility for foreign exchange policy. During that period the Canadian exchange rate was not fixed. The Bank held Canada's official gold reserves (The Bank of Canada Act of 1934 provided that the gold held by the Minister of Finance for the redemption of Dominion notes and the gold held by the chartered banks should be transferred to the Bank of Canada. The Act also provided that Bank of Canada notes should be redeemable in gold and that a gold reserve of at least 25 per cent be maintained against the Bank's outstanding note and deposit liabilities. The gold redemption requirement has neen suspended each year since 1934 by order-in-council under Section 22 of the Bank of Canada Act. The gold reserve requirement was withdrawn in 1940 by the Exchange Fund Order, and this withdrawal was continued by subsequent legislation -- since 1952 by the Currency, Mint and Exchange Fund Act -- subject to reimposition by order-in-council.) and such stabilizing operations in the foreign exchange market as were deemed necessary were conducted by the Bank for its own account. The Exchange Fund Act of 1935 made provision for the setting up of a Fund to be used by the Minister of Finance to influence the foreign exchange rate, but this power was not invoked until the beginning of the War when the Government imposed foreign exchange control by order-in-council under the War Measures Act, fixed the buying rate for United States dollars at 110 cents Canada (i.e. at a rate of one Canadian dollar equalling 90.9 United States cents), and empowered the newly-

control on the outbreak of war [illegible] 1939 [illegible] carried some direct responsibility for foreign exchange policy. During that period the Canadian exchange rate was not fixed. The Bank held Canada's official gold reserves (the Bank of Canada Act of 1934 provided that the gold held by the Minister of Finance for the redemption of Dominion notes and the gold held by the chartered banks should be transferred to the Bank of Canada. The Act also provided that Bank of Canada notes should be redeemable in gold and that a gold reserve of at least 25 per cent be maintained against the Bank's outstanding note and deposit liabilities. The gold redemption requirement has been suspended [illegible] 1934 by order-in-council under Section 22 of the Bank of Canada Act. The gold reserve requirement was suspended in 1940 by the Exchange Fund Order, and this suspension was continued by subsequent legislation [illegible] the Currency, Mint and Exchange Fund Act [illegible] requisition by order-in-council and such other [illegible] operations in the foreign exchange market [illegible] necessary were conducted by the Bank [illegible] The Exchange Fund Act of 1935 made provision for the setting up of a fund to be used by the Minister of Finance to influence the foreign exchange rate, but this power was not invoked until the beginning of the war when the Government imposed foreign exchange control [illegible] [illegible] rate for [illegible] Canada (i.e. at a rate of one Canadian dollar [illegible] 90.9 United States cents) and [illegible]

constituted Foreign Exchange Control Board subject to instructions from the Minister of Finance, to use the Exchange Fund Account in maintaining the fixed buying and selling rates for foreign exchange. In 1940 an order-in-council required that the gold held by the Bank of Canada be transferred to the Exchange Fund, which also acquired other foreign exchange assets held by Canadian residents. The fixed exchange rate system was suspended in October, 1950, and a floating exchange rate system established. The previous authority for the Exchange Fund Account was replaced in October 1952 by the Currency, Mint and Exchange Fund Act under which the Exchange Fund Account was continued as a special account in the name of the Minister of Finance. In May 1962, the Government reverted to a fixed exchange rate, and under the authority of the Bretton Woods Agreement Act established with the International Monetary Fund a par value for the Canadian dollar of 92½ United States cents.

3. The preamble of the Bank of Canada Act provides that one of the purposes of the central bank is to "control and protect the external value of the national monetary unit", and in its monetary management the Bank must, of course, take account at all times of the foreign exchange situation, and the need to maintain a sound external financial position. However, as stated above, since 1939 the direct responsibility for foreign exchange policy has been assumed by the Government and decisions regarding the determination of the exchange rate and the conduct of official foreign exchange operations

[illegible] Bank [illegible] [illegible] [illegible]

[illegible] from the Minister of Finance [illegible]

Exchange Fund Account [illegible] maintaining [illegible]

and selling rates for foreign exchange. [illegible]

[illegible] it required that the gold held [illegible]

of Canada be transferred to the Exchange Fund. [illegible]

also acquired other foreign exchange assets held [illegible]

Canadian residents. The Foreign Exchange [illegible]

suspended in October, [illegible], and a [illegible]

[illegible] established. The previous [illegible]

Exchange Fund Account was [illegible]

by the Currency, Mint and Exchange Fund Act [illegible]

the Exchange Fund Account was [illegible] as [illegible]

account in the name of the Minister of Finance. [illegible]

[illegible], the Government [illegible] [illegible]

and under the authority of the [illegible] Act [illegible]

[illegible]

par value for the Canadian dollar [illegible]

States [illegible].

5. The [illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

[illegible]

the conduct of [illegible]

are Government decisions. Foreign exchange operations in support of the Government's foreign exchange policy are carried out by the Exchange Fund Account with the Bank of Canada carrying out buying and selling transactions in foreign exchange on its behalf on instructions from the Minister of Finance.

on Government decisions. Foreign exchange operations [illegible] [illegible] Bank of Canada carrying out buying and selling operations in foreign exchange on the [illegible] of instructions from the Minister of Finance.

B. Some General Considerations Relating to Foreign Exchange

4. Canadians engage in international trade on a very large scale; over one-fifth of all the goods and services produced in Canada are sold abroad and about the same proportion of all the goods and services used by Canadians originate outside our borders. In addition, Canadians engage in extensive international transactions in a wide variety of financial obligations, such as bonds and stocks, and in titles to property. Virtually all of Canada's international transactions are affected by the rate at which Canadian currency and foreign currency can be exchanged in the foreign exchange market for this rate is the link between prices in Canada and prices abroad. These international flows of goods and services and of capital are so large that they have important effects on almost every aspect of Canadian economic life, and the foreign exchange rate is almost certainly the most important single price in Canada.

5. Canada's foreign exchange rate at any particular time is that established in the foreign exchange market, which is open through the medium of the banking system to anyone who wants to exchange Canadian dollars for foreign currencies or vice versa. During the decade of the 1950's this rate moved as required to maintain the balance of demand and supply with official intervention of the Government's Exchange Fund Account limited to moderating short-run fluctuations. Since May 2, 1962, the Government has undertaken, in accordance with the provisions of the International

Some General [illegible] Relating to [illegible] Exchange

4. [illegible]

[illegible] very large [illegible] goods and services produced in Canada are sold abroad and [illegible] the same proportion of all the goods and services used [illegible] Canadians constitute [illegible] [illegible] [illegible] in extensive international [illegible] in a wide variety of financial [illegible] bonds and stocks, and in [illegible] All of Canada's international [illegible] by the rate at which [illegible] currency can be exchanged [illegible] the [illegible] rate is the link between [illegible] abroad. These international [illegible] services and of capital [illegible] important effects on almost every [illegible] economic life, and the foreign exchange rate [illegible] potentially the most important single [illegible]

5. Canada's foreign exchange [illegible]

[illegible] time is that [illegible] exchange market, which [illegible] the banking system [illegible] pegged [illegible] [illegible] the [illegible] required to maintain [illegible] [illegible] international [illegible]

[illegible]

Since May 2, 1962, [illegible] [illegible] accordance with [illegible]

Monetary Fund, to keep the exchange rate of the Canadian dollar within 1 per cent on either side of the par value of 92½ United States cents, and the Exchange Fund buys or sells foreign currency in the market in such volume as may be necessary for this purpose.

6. There are many underlying factors which can give rise to changes in the demand for and the supply of foreign exchange. One important factor is the general trend of prices in Canada relative to prices in other countries, especially in prices of goods and services that are or can be traded internationally, since a change in relative prices will tend to alter the balance between exports and imports of goods and services and the related supply of and demand for foreign exchange. The trend of Canadian production, income and demand for goods and services relative to that in other countries is another important factor; the level of Canadian imports of goods and services is sensitive to short-run changes in the level of total income in Canada, while the level of exports is sensitive to changes in the level of total income in the countries to whom we export. Changes in the composition of demand in Canada or abroad, e.g., in the strength of capital investment demand or in consumer tastes and customs, can also cause changes in the level of imports or exports. Changes in credit conditions in Canada relative to those abroad, especially in the United States, can give rise to substantial shifts in the international trade in portfolio securities and in similar capital movements. Changes in business organization and inter-company relationships, in taxation and tariffs, and

[illegible] y fund, to keep the [illegible] of the [illegible]

[illegible] which 1 [illegible] cent [illegible]

[illegible] United States cents, and the exchange [illegible]

[illegible] of a foreign currency [illegible]

[illegible] or may be necessary [illegible]

6. There are many underlying factors [illegible] can give rise to changes in the demand [illegible] and [illegible] of foreign exchange. One [illegible] trend of prices in Canada relative to [illegible] countries, especially in [illegible] can [illegible] between exports and imports of goods and services [illegible] supply of [illegible]

[illegible] another important factor, [illegible] goods and services [illegible] level of [illegible] imports is [illegible] in the countries [illegible] the [illegible] of [illegible] countries [illegible] of exports [illegible] relative to those [illegible] capital movements. [illegible]

in terms of access to foreign markets can also give rise to changes in the international flow of both goods and capital.

7. The range of Government action that may affect our foreign exchange position is a wide one. The most apparent is direct intervention in the foreign exchange market in such volume as may be necessary to maintain the exchange rate within fixed limits, but in the longer run direct intervention by the Government in the exchange market is not the principal means available for affecting the foreign exchange situation. Over a period of time it is necessary to combine various public economic policies in such a way that the underlying factors influencing the demand for and the supply of foreign exchange will cause the rate to remain within the fixed limits without large and sustained official intervention in the exchange market in one direction. Direct intervention is primarily a means of dealing with temporary disturbances or providing time for other policies to have their effects. The principal arms of public financial policy -- fiscal policy, monetary policy and debt management policy -- can play an important role. Each of them can seek to influence the level and character of spending and international capital movements in a manner which is compatible with a stable foreign exchange position. In addition, many Government policies that are not basically financial in character can be important in this connection because they can have important effects on the international flow of trade and capital.

[illegible]

[illegible]

7. The range of [illegible] government [illegible] [illegible] foreign exchange position is a wide one. [illegible] most apparent is direct intervention in the foreign exchange market [illegible] every variety [illegible] maintain the exchange rate within fixed limits [illegible] no longer confined to intervention by [illegible] the exchange market is not the place [illegible] affecting the foreign exchange [illegible] of time it is necessary [illegible] economic policies [illegible] say that the [illegible] factors influencing the demand [illegible]

[illegible]

8. Different combinations of public economic policies have different effects on the size of the surplus or deficit on current international transactions in goods and services and the size of the net inflow or outflow of capital. The balances on current account and on capital account must be approximately offsetting if the requirements of over-all balance are to be met, but other aspects of the performance of the economy are much affected by the size of the surplus or deficit on current account and the corresponding magnitude of capital flows. Consideration of these other aspects may thus influence the particular combination of public economic policies that is preferred.

... r have different effects on the rate of th...

...rplus or def[illegible] in current international transactions in goods and services and the size of the net inflow of capital [illegible]. [illegible] and [illegible] a [illegible] must be approximately [illegible]. If [illegible] adjustments or overall balance [illegible] but other aspects of the performance of [illegible] both affected by the size of the surplus [illegible] current account and the corresponding [illegible] in capital flows. Consideration of these other [illegible] [illegible] thus influence the [illegible] economic policies that is preferred.

C. Bank of Canada Operations in Foreign Exchange

9. The Bank of Canada engages in few transactions in foreign exchange for its own account. Most of the transactions put through the inter-bank market by the Bank of Canada's foreign exchange traders are for clients, particularly the Exchange Fund Account. All official foreign exchange transactions specifically directed at influencing conditions in the foreign exchange market are done for the Exchange Fund Account, which holds the great bulk of the official holdings of gold and United States dollars. (The official holdings of United States dollars also include the small net holdings of the Bank of Canada and the working balances of the Minister of Finance.) The Exchange Fund is prepared to buy or sell exchange in the amounts necessary to keep the rate of exchange within one per cent of the declared par value.

10. To buy foreign exchange the Exchange Fund needs Canadian dollars and these are provided by advances from the Consolidated Revenue Fund made under the provision of the Currency, Mint and Exchange Fund Act of 1952. Exchange Fund operations can therefore have a considerable effect on the financial position of the Government. If reserves are being accumulated, they must be financed by use of the Government's Canadian dollar cash balances and this may involve additional borrowing. When the Exchange Fund is selling foreign exchange and repaying advances, the Government's Canadian dollar cash position is improved. These advances or repayments of Canadian dollars naturally have a bearing on domestic

credit conditions and on fiscal, monetary and debt management policies.

II. The latest published balance sheet of the Exchange Fund at December 31, 1961 may be summarized as follows:

ASSETS

	Millions of Canadian Dollars
Short-term United States Government Securities	1,104
Gold	987
United States Dollar Deposits	25
Canadian Dollar Deposits	1
Revaluation (Deficit) Account	46
Total Assets	2,163

LIABILITIES

Advances outstanding	2,130
Earnings on Investment in 1961 not yet transferred to Consolidated Revenue Fund	33
Total Liabilities	2,163

12. The Bank of Canada manages the Exchange Fund's portfolio of United States Government Treasury Bills and other short-term securities and makes changes therein which are consistent with the Fund's changing need for liquidity and with the desire for earnings. Interest earnings from the portfolio augment the foreign currency holdings of the Exchange Fund. After the end of each year their Canadian dollar equivalent is paid to the Government and recorded as budgetary revenue. The Revaluation (Deficit) Account as shown above reflected mainly the revaluation of foreign currency assets into

Canadian dollars at the current rates of exchange. With the Exchange Fund's holdings of gold and foreign exchange valued at the par value established in May 1962, the Revaluation Account shows a surplus.

13. The Bank of Canada acts as a depository for the gold owned by the Exchange Fund and also accepts deposits of gold for safekeeping from central banks and international institutions. As depository, the Bank makes arrangements for physical shipment of gold or the transfer of its ownership from one earmarked account to another. The Bank of Canada buys and sells gold for the Exchange Fund including newly mined gold acquired from the Royal Canadian Mint. In marketing gold it is the practice to sell only to foreign central banks, foreign governments and international institutions such as the International Monetary Fund and the Bank for International Settlements. A small quantity of the gold owned by the Exchange Fund is held in safekeeping outside Canada to facilitate deliveries to buyers.

14. The Bank is permitted by the Bank of Canada Act to open accounts in a central bank in any country. Such accounts are, of course, needed to conduct the Bank's foreign exchange transactions. Since the bulk of the dealings in the Canadian exchange market are in United States dollars and sterling, the two most important accounts carried by the Bank abroad are those with the Federal Reserve Bank of New York and the Bank of England. Through these accounts pass the market transactions of the Bank in United States dollars and sterling as well as transactions in these currencies for various

Canadian dollars at the current rates of exchange. With the Exchange Fund's holdings of gold and foreign exchange valued at the par value established in May 1962, the Exchange Fund Account shows a surplus.

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11. The Bank is permitted by the Bank of Canada Act to open accounts in a central bank in any country. Such accounts are, of course, needed in order to [illegible] Canada's foreign exchange transactions. Since the bulk of the dealings in the Canadian exchange market are in [illegible] dollars and sterling, the [illegible] accounts operated by the Bank abroad are with the Federal Reserve Bank of New York and the Bank of [illegible]. Through these accounts pass the bulk of the [illegible] of the Bank in United States dollars and sterling [illegible] transactions in these currencies [illegible]

government departments and other customers of the Bank. In addition the Bank maintains accounts with central banks in a number of other countries. These accounts enable the Bank to make payments by cable and to issue drafts in the appropriate foreign currencies as required by government departments. The heaviest requirements are those of the Departments of Finance and National Defence but the needs of the Post Office and Department of Trade and Commerce and External Affairs, though smaller in individual amounts, are numerous and diverse. The foreign currencies to supply these accounts are sometimes obtained in the local inter-bank market and sometimes in New York or London, but it is usually more advantageous as well as more expeditious to buy foreign currencies from the central banks concerned in exchange for Canadian dollars or United States dollars.

15. The Bank of Canada Act authorizes the Bank to act as agent, depository or correspondent for other central banks and certain international institutions. Deposit accounts denominated in Canadian dollars are maintained at the Bank of Canada by more than twenty central banks, the Bank for International Settlements, the International Monetary Fund and the International Bank for Reconstruction and Development. In connection with these deposits the Bank provides its clients with the usual services of receiving cash, cheques, coupons and other items for clearance of collection and credit to the depositor's account and making payments in respect of drafts and under instructions received by cable or mail. The Bank has no facilities for effecting collections of

documentary or other commercial bills of exchange and central banks which conduct commercial business route their commercial transactions through Canadian chartered banks. The Bank is not permitted by the Bank of Canada Act to pay interest on deposits. Some central bank depositors give standing instructions to employ their balances in excess of a certain amount in treasury bills; others give instructions from time to time to purchase (or dispose of) treasury bills for their account and sometimes to tender for new bills at the weekly offering.

16. The United States dollar deposit accounts maintained with the Bank of Canada by its overseas customers are few in number and not very active. Several are primarily funds left on deposit with the Bank to compensate for services rendered by the Bank in the storage of gold. A more active United States dollar account is kept for the Minister of Finance. The funds which pass through this account are derived from large payments received by the Government from various sources and from purchases made in the Canadian market. In addition, the gold bought by the Exchange Fund from the Mint is paid for with United States funds which are credited to this account. The account is used to keep the Minister's various operating accounts in New York in funds and on occasion for direct payment by telegraphic transfer. An account denominated in sterling is also carried in the name of the Minister.

17. The Bank assembles current information on the market quotations for the monetary units of different countries and territories and acts as a general

[illegible] rtia. [illegible]

[illegible]

[illegible] commercial transactions through [illegible]. The Bank is not permitted by the Bank of [illegible] Act to pay interest on deposits. Some [illegible] depositors give standing instructions to [illegible] their balances in excess of a certain amount in treasury bills; others give instructions from time to time to purchase (or dispose of) treasury bills for their account and sometimes to tender for new bills at the weekly offering.

3. The United States dollar deposits [illegible] maintained with the Bank of [illegible] by the [illegible] are few in number and [illegible] very [illegible]. Some are primarily [illegible] left on deposit with the Bank to compensate for services rendered by the Bank in the [illegible] of gold. A more active [illegible] account is kept for the Minister of Finance. [illegible] pass through this account [illegible] received by the [illegible] and from purchases [illegible] in the [illegible]. In addition, the gold bought by the [illegible] is paid for [illegible] United States [illegible] credited to this account. [illegible] the Minister's various operating [illegible] account for [illegible] payment [illegible]. An account [illegible] in sterling [illegible] to the [illegible] of the [illegible].

4. The Bank [illegible] the [illegible] for the [illegible]

[illegible]

source of foreign exchange information for all government departments and agencies. The Canadian dollar price which the Minister of Finance pays for the Canadian-produced gold is based on the weekly average of noon rates on the United States dollar reported to him by the Bank of Canada.

18. The Bank's Statement of Assets and Liabilities, published for each Wednesday and each month-end, shows foreign exchange items under various headings. On the liability side item 5 "Liabilities payable in pounds sterling, U.S.A. dollars and other foreign currencies" needs little explanation. It gives the Canadian dollar equivalent of the total foreign currency balances held on deposit by the Bank for its customers. The total is broken down into (a) "Government of Canada" (i.e. the United States dollar working balance of the Exchange Fund and the various foreign currency accounts of the Minister of Finance) and (b) "Others" (i.e. foreign currency accounts, principally United States dollars, of foreign central banks and governments and international institutions). On the asset side item 2 "Foreign exchange" represents the Canadian dollar equivalent of the foreign currency held on deposit in the name of the Bank by the Bank's various banking correspondents abroad. It is broken down into (a) "Pounds sterling and U.S.A. dollars" and (b) "Other currencies". This figure includes only cash balances. Foreign currencies owned by the Bank of Canada which have been temporarily invested and are held by the correspondents in the form of short-term securities

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appear in item 6(f) "Other securities" under the head of "investments". By adding together the two items on the asset side and deducting the item on the liability side the Canadian dollar equivalent of the net foreign exchange holdings of the Bank for its own account can readily be ascertained. On May 31, 1962 the Bank's net foreign exchange holdings were $11.2 million.

APPENDIX I

THE INTERNATIONAL MONETARY FUND

19. The International Monetary Fund came into being in December 1945 following the 1944 Bretton Woods United National Monetary and Financial Conference where its Articles of Agreement were drawn up. It is one of a number of institutions which were established to promote international cooperation in particular fields. Its purposes are:

(i) "To promote international monetary co-operation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.

(ii) To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of a multilaterial system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

[illegible]

[illegible]

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(iii) To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.

(iv) To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

(v) To give confidence to members by making the Fund's resources available to them under adequate safeguards, thus providing them with opportunity to correct maladjustment in their balance of payments without resorting to measures destructive of national or international prosperity.

(vi) In accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members."

20. The main authority of the Fund is lodged in the Board of Governors who meet once a year. Each country appoints a Governor. The Governors have delegated many of their powers to the eighteen member Executive Board. Five directors are appointed by the countries which have paid the largest subscriptions and the others are elected by the other member countries. Canada has had a director on the Executive Board since the inception of the Fund. The administrative staff of the Fund is headed by a Managing Director.

21. The functions of the International Monetary Fund may be summarized under three headings -- the maintenance of exchange stability, the avoidance of impediments to trade resulting from currency restrictions or discrimination and the provision of short-term assistance to members experiencing temporary balance of payments difficulties.

22. Members of the International Monetary Fund are obligated under Article IV to declare par values for

their currencies expressed in terms of gold as a common denominator or in terms of United States dollars of the weight and finances in effect on July 1, 1944, and to maintain their exchange rates within one per cent on either side of this par value. Changes in par values may be made only after consultation with the Fund, and to correct a fundamental disequilibrium. The initial declared par value for the Canadian dollar established on December 18, 1946, was 100 United States cents per dollar. In September 1949 following the devaluation of sterling the Canadian dollar was fixed at 90.9 United States cents per dollar and remained there until September 1950. At that time Canada suspended the fixed rate system and allowed the Canadian dollar to find its own level in the exchange market. The Fund's Executive Board decision concerning this matter stated that it recognized "the exigencies of the situation which have led Canada to the proposed plan and takes note of the intention of the Canadian Government to remain in consultation with the Fund and to re-establish an effective par value as soon as circumstances warrant." In May 1962 a par value of 92½ United States cents per Canadian dollar was established. At the time of this action the International Monetary Fund stated that "the step thus taken by the Canadian authorities represents the return to a fixed par value system by Canada and this is warmly welcomed by the Fund".

23. Members of the Fund are obliged by Article VIII not to impose restrictions on current payments without the approval of the Fund,and to avoid

of its currencies expressed in terms of gold as a common denominator or in terms of United States dollars of the weight and fineness in effect on July 1, 1944, and to maintain the exchange rates within one per cent on either side of this par value. Changes in par values may be made only after consultation with the Fund, and to correct a fundamental disequilibrium. The initial declared par value for the Canadian dollar established on December 18, 1946, was 100 United States cents per dollar. In September 1949 following the devaluation of sterling the Canadian dollar was fixed at 90.9 United States cents per dollar and remained there until September 1950. At that time Canada suspended its fixed rate system and allowed the Canadian dollar to find its own level in the exchange market. The Fund's Executive Board decision concerning this matter stated that it recognized "the exigencies of the situation which have led Canada to the proposed plan" and "took note of the intention of the Canadian Government to remain in consultation with the Fund and to re-establish an effective par value as soon as circumstances warrant". In May 1962 a par value of 92.5 United States cents per Canadian dollar was established. At the time of this action the International Monetary Fund stated that "the step thus taken by the Canadian authorities [illegible] the return to a fixed par value [illegible] is warmly welcomed by the Fund".

23. Members of the Fund are obliged by Article VIII not to impose restrictions on current payments without the approval of the Fund and not to

discriminatory currency practices. However, it was recognized when the Articles of Agreement were drafted that many countries would not be able to abaondon war-time restrictions at once, and Article XIV of the Agreement authorized members to maintain and adapt exchange restrictions, without prior approval of the Fund, during a transitional period of indeterminate length. Members operating under Article XIV were, however, required to consult annually with the Fund concerning the maintenance of such restrictions. Before 1961 only ten countries, all of them in the Western Hemisphere (including Canada since March 1952), fully accepted the obligations of convertibility and non-discrimination embodied in Article VIII. In 1961 ten more countries (of which nine were Western European), which had previously availed themselves of the provisions of Article XIV, accepted the obligations of Article VIII. This important action formally recognized the restoration of convertibility of the world's major currencies and underlined the progress which had been made in restoring balance in the international payments system. The Fund expressed a desire to continue the procedure of annual consultations which had been found useful in relation to the Article XIV countries, and in response to this initiative countries adhering to Article VIII agreed to have voluntary annual consultations with the Fund. The first such consultation between the Fund and Canada took place in February 1962.

24. One of the most important and best known aspects of the Fund's operations is the provision of

financial assistance to members experiencing temporary balance of payments disequilibrium. Assistance may take the form either of a drawing, repayable within three to five years, which immediately provides additional foreign exchange to a member, or a "stand-by" arrangement assuring a member the right to draw a predetermined amount of foreign exchange any time within a 12-month period. Total drawings by members had exceeded the equivalent of U.S. $6¼ billion. Members borrowing from the Fund draw resources from the pool which members have contributed, and it is the practice to draw those currencies which are convertible and relatively strong. The amount of the contributions and the drawing rights of each member are determined by the size of the quota. Canada's original quota was U.S. $300 million; it was raised to U.S. $550 million in 1959 when a major increase was made in the Fund's resources. It amounts to 3.7 per cent of the total quotas of U.S. $15,057 million of the 76 members of the Fund as of April 30, 1962. In accordance with the standard practice, Canada's subscription, equal to its quota, was paid in gold to the extent of 25 per cent and in the form of non-interest bearing demand notes of the Government of Canada to the extent of 75 per cent.

25. When a member obtains financial assistance from the Fund by drawing foreign exchange it pays for it with its own currency. A drawing which would increase the Fund's holdings of the borrower's currency to 100 per cent of quota is viewed as borrowing back the gold

originally subscribed and members are given "the overwhelming benefit of the doubt" in requests for drawings within this so-called "gold tranche". The Fund takes "a liberal attitude" toward drawings in the "first credit tranche", i.e. drawings which increase the Fund's currency holdings of the member above 100 per cent but not above 125 per cent of quota. Drawings beyond this point require "substantial justification". Article V places a maximum of 200 per cent on the Fund's holdings of a member's currency, but this could be "waived" by the Board.

26. Canada has not borrowed from the Fund, but Canadian dollars have been drawn on three occasions; the Canadian dollar equivalent of U.S. $15 million by Egypt in 1956, U.S. $10 million by Australia in 1961 and U.S. $75 million by the United Kingdom in 1961. Such drawings have the effect of increasing Canada's drawing rights while repayments in Canadian dollars have the reverse effect. As at May 31, 1962, the Fund's holdings of Canadian dollars amounted to the equivalent of U.S. $388 million; the amount which Canada could draw within the so-called "gold tranche" was U.S. $162 million. A drawing of the gold tranche and the first three credit tranches would yield U.S. $574 million, and a drawing to 200 per cent of quota would produce U.S. $712 million.

27. As indicated in paragraph 23, the attainment of one of the Fund's main goals, widespread convertibility, resulted in 1961 in the acceptance of the obligations of Article VIII by a number of countries of

originally subscribed and members are given "the overwhelming benefit of the doubt" in requests for drawings within this so-called "gold tranche". The Fund takes "a liberal attitude" toward drawings in the "first credit tranche", i.e. drawings which increase the Fund's currency holdings of the member above 100 per cent but not above 125 per cent of quota. Drawings beyond that point require "substantial justification". Article V places a maximum of 200 per cent on the Fund's holdings of a member's currency, but this could be "waived" by [illegible].

26. Canada has not borrowed from the Fund, but Canadian dollars have been drawn [illegible] the Canadian dollar equivalent of U.S. $[illegible] million by Egypt in 1956, U.S. $10 million by Australia [illegible] and U.S. $15 million by the United Kingdom [illegible]. [illegible] drawings have the effect of increasing Canada's [illegible] while repayments in Canadian dollars have the reverse effect. As at May 31, 1961, the Fund's holdings of Canadian dollars amounted to the [illegible] of U.S. $[illegible] millions, the amount [illegible] within the so-called "gold tranche" was U.S. $[illegible] millions. A drawing of the gold tranche and the first [illegible] credit tranches would yield U.S. $[illegible] amounting to 200 per cent of [illegible] [illegible].

27. As indicated in paragraph [illegible], the [illegible] of one of the Fund's [illegible] goals [illegible] convertibility, resulted in [illegible] the [illegible] obligations of Article VIII by a [illegible]

Western Europe. This welcome development brought in its wake large scale movements of short-term capital from one country to another and raised the question of the adequacy of the Fund's resources to maintain the international payments system. In order to avoid any undesirable impact on the operation of the international payments mechanism from these developments, it seemed advisable to strengthen the resources available to the Fund. The course chosen was for the Fund to reach a decision on general arrangements by which it might borrow supplementary resources under Article VII of the Fund Agreement to be used, if necessary, to support the international payments system. The ten main industrial countries, including Canada, agreed in January 1962, subject to legislative approval, to lend their currencies to the Fund up to specified amounts when the Fund and these countries decide that supplementary resources are needed to forestall or cope with an impairment of the international monetary system. The total amount of such supplentary resources is U.S. $6 billion of which Canada's commitment will be U.S. $200 million. Use of these supplementary resources will be in accordance with the Fund's established policies and practices with respect to the use of its resources, including the time period of three to five years. The Fund will repay the countries that made the supplementary resources available when it receives repayment, and in any case not later than five years after the borrowing. In addition, a country that has lent to the Fund can receive early repayment upon request if its own payments situation has deteriorated. Rights to repayment are fully backed by all the assets of the Fund.

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APPENDIX II

THE FOREIGN EXCHANGE MARKET IN CANADA

28. The hub of the foreign exchange market in Canada is the inter-bank market. Farther out is an inner rim consisting of the head office foreign departments of the banks who, in effect, act as wholesalers of exchange. Beyond that again is an outer rim consisting of the branch banks with whom the public conduct their dealings and who may be likened to retailers. In this category are also the post office, express companies and other organizations who provide a service in money orders, travellers' cheques, etc.

29. The inter-bank market is centred in Montreal and Toronto where the chartered banks have their head offices. Neither non-resident banks or resident investment and financial houses, commercial and industrial corporations have direct access to this market, which is limited to the chartered banks and Bank of Canada. It has no written constitution, rules, or regulations but follows informally agreed procedures and traditional patterns of behaviour.

30. The banks do not deal with each other directly but exclusively through the medium of brokers with whom they place buying orders (bids) or selling orders (offers) for stated amounts of exchange at specified prices. The function of the broker is to bring buyers and sellers together until a mutually acceptable rate is agreed upon and a deal made.

31. Brokers do not themselves hold exchange positions or buy and sell for their own account; nor do

[illegible]

THE FOREIGN EXCHANGE MARKET IN CANADA

28. The hub of the foreign exchange market in Canada is the inter-bank market. Further out is an inner rim consisting of the head office foreign departments of the banks who, in effect, act as wholesalers of exchange. Beyond that again is an outer rim consisting of the branch banks with whom the public conduct their dealings and who may be likened to retailers. In this category are also the post office, express companies and other organizations who provide services in money orders, travellers' cheques, etc.

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31. Brokers do not themselves hold positions or buy and sell for their own account [illegible]

they have any hand whatsoever in the ultimate completion of the deal. When the deal has been arranged they send a confirmation to each of the principals. The confirmation sets out the amount, the rate, the date on which and the manner in which payment is to be effected. The brokers' job is then finished. Thereafter the banks complete the transaction directly with each other, the one making delivery of the exchange to the account of the buyer in a bank in the foreign centre nominated by him and the other making payment of the Canadian dollar equivalent locally.

32. There is a broker's office in Montreal and one in Toronto, each in direct telephone connection with the chartered banks and the Bank of Canada. The two brokers in each office are paid fixed salaries by the Canadian Bankers' Association who also provide office space and pay office expenses. This is a feature in the foreign exchange system in Canada which differs from the custom of exchange markets in other centres. It differs also from the pattern followed here before September 15, 1939. Up to that time, in common with exchange markets elsewhere, brokers obtained their remuneration by charging a commission, or brokerage, on each deal on an agreed percentage basis. (This brokerage varied in Canada from time to time in the inter-war period but was 1/64 per cent in 1939.) The brokers paid their own expenses and were in business for themselves, though they could not, of course, deal for their own account, and accepted orders only from Canadian banks. The Macmillan Commission Report mentions that in 1933 there were six

they have any [illegible] whatsoever [illegible]
of the [illegible] [illegible]
a qualification [illegible] of one [illegible]
[illegible]
[illegible]
[illegible] Finland. [illegible]
[illegible]
[illegible]
[illegible]
[illegible] and the other [illegible]
equivalent [illegible]

[illegible] is a [illegible]
[illegible] in Finland [illegible]
[illegible]
[illegible]
[illegible]
[illegible]
[illegible]
[illegible]
[illegible]
[illegible]
[illegible]
[illegible]
[illegible]
[illegible]
[illegible]
[illegible]
[illegible]
[illegible]

brokers in Montreal and two in Toronto.

33. The minimum lot for trading is $100,000. Dealings may be for spot exchange (in which delivery is normally made on the next banking day common to both centres concerned), for forward exchange (in which delivery is made on an agreed future date) and for exchange swaps (in which purchases of exchange for spot delivery are made simultaneously against sales of like amounts for forward delivery).

34. While trading in spot exchange is conducted in the market on the basis of the value of the foreign currency in terms of the Canadian dollar, forward exchange is quoted on the basis of the difference (spread) between the value of spot and forward expressed as a premium or discount. Thus United States dollars for ninety days forward delivery may be quoted at "1/8¢ premium" over spot; "1/32¢ discount" on spot etc.; ninety day sterling might be quoted at "½¢ premium"; "¼¢ discount" etc. On swap transactions it is only after the broker has brought buyer and seller together on the basis of the spread that the actual value to be put on both the spot and forward ends of the deal is agreed. Before the war it was difficult to arrange forward transactions either outright or in the form of swaps for longer periods than three months. The situation has improved considerably and trading for periods up to six months ahead is normal. Deals for much longer periods are harder to arrange but do, at times, go through the market.

35. Imports and exports and many other kinds of

business operations give rise to forward exchange transactions by which people protect themselves against exchange risk. In the simplest case, an exporter expecting to receive foreign exchange at a specific date in the future will sell it forward to his bank; an importer committing himself to pay foreign exchange at a specific date in the future will buy it forward from his bank. When it is not feasible for the client to name a precise date at which he can make or take delivery of the exchange, the bank may arrange the contract to give him the option to deliver within a stated period of 15 days or a month. Swap transactions may arise in a variety of situations. Banks do not usually balance off a forward position which they have entered into with their clients by looking to the inter-bank market for an offsetting outright forward transaction corresponding as to date, but instead hedge the greater risk of the spot rate first by a spot deal, waiting for an opportune time to cover the secondary risk of the forward premium or discount. In consequence the turnover in the market for swaps is greater than for outright forwards.

36. In recent years there has been considerable activity in a "swap-and-investment" technique known as "interest arbitrage" which consists of making use of exchange swaps to convert liquid funds into the currency of another country for investment in short-term securities in order to obtain a better yield than can be obtained on a similar class of investment in one's own country. If the yield on United States treasury bills is 3/4 per cent below the yield on Canadian treasury bills,

and the Canadian dollar can be bought spot and sold forward at a discount equivalent to $\frac{1}{4}$ per cent annually, Canadian treasury bills offer a yield higher by $\frac{1}{2}$ per cent on a covered basis to United States investors. Operations of this type have been known for many years, particularly in Europe, but the volume has increased greatly in recent years as exchange restrictions imposed during the war have been modified or withdrawn. Interest arbitrage dealings in Canada were of no great importance until the past few years but are now very substantial. The principal participants are the banks themselves, investment houses, insurance companies and similar financial concerns, who have large holdings of liquid funds at all times, and industrial corporations and public bodies who may from time to time have funds for temporary investment. The effect of interest arbitrage when undertaken in volume is of course ultimately to bring the net yields available in such operations sufficiently in line that they are no longer attractive.

37. Almost all dealings in the inter-bank market are in United States dollars and sterling. These are international currencies in the sense that they are used in world trade between countries other than the United States and the United Kingdom. Prices of many commodities are quoted and trade conducted in terms of one or other of these currencies as also are freight and insurance. Only a small proportion of Canada's external trade is denominated in Canadian dollars; to trade in terms of Canadian dollars would be simpler for residents of Canada, but less convenient for non-residents

and might involve some additional cost in covering exchange. In the main, banks cover their requirements of the currencies of other countries by going through New York or London or by the sale of United States dollars, sterling or Canadian dollars in the country whose currency is needed. Nevertheless transactions are occasionally arranged in the market here in the currencies of Continental European countries.

38. There has been a large increase in the turnover in the foreign exchange market since the pre-war period. Perhaps the most important reason is the elimination of the brokerage; traders are no longer deterred from placing a selling order in the market even though they believe that later in the day they might have a buying order from a customer which would absorb all or part of the amount they are offering in the market. Whereas up to 1939 the Canadian banks took a great part of their dollar exchange business to New York the tendency now appears to be for the New York banks to bring their business to Canada. There has been a large increase in the volume of forward transactions, particularly swap transactions; this reflects the more widespread practice among the banks' customers of covering their exchange risk forward, and the more active participation by Canadian investment houses and banks in interest arbitrage transactions.

39. It should perhaps be noted that the inter-bank market turnover which amounted to almost $2 billion in 1961 is only a fraction of the sum total of Canada's international dealings in the course of a year, Canada's

international transactions on current account alone exceeded $16 billion in 1961. The explanation is that with only a relatively few banks, each constitutes a considerable market in itself; banks are able to offset or "marry" their purchases and sales largely within their own systems and only need have recourse to the inter-bank market to dispose of surplus receipts or to cover net deficiencies. The size of the market turnover will vary according to the random way in which purchases and sales offset each other or fail to do so in each bank's own internal operations.